United States
Department of
Agriculture

Economics
and Statistics
Service

Agricultural
Economic
Report
Number 468

Economic and Federal Tax Factors Affecting the Choice of a Legal Farm Business Organization

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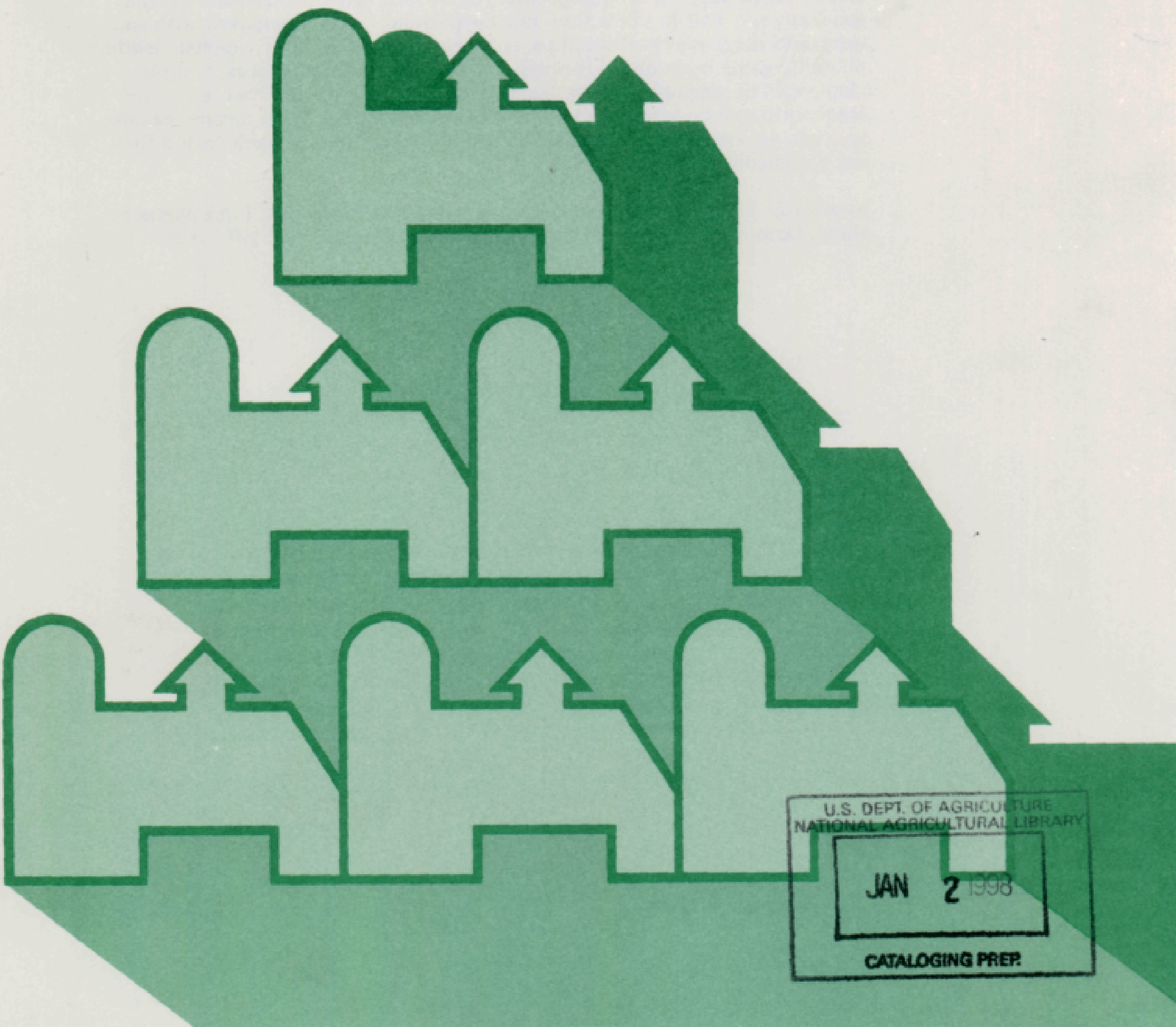

Economic and Federal Tax Factors Affecting the Choice of a Legal Farm Business Organization, by Michael Boehlje and Kenneth Krause. National Economics Division, Economics and Statistics Service, U.S. Department of Agriculture. Agricultural Economic Report No. 468.

Abstract

Recently reduced corporate income tax rates and inflation-induced higher tax rates for individuals provide incentives for farmers with taxable incomes above $25,000 to incorporate. Above that level, incorporated farms generally pay less in taxes than unincorporated farms. Compared with sole proprietorships and partnerships, corporations can often accomplish estate planning goals more easily through use of stock and debentures, can purchase certain employee fringe benefits at a lower after-tax cost, and can frequently reduce income taxes further by dividing the farm income among multiple entities (two or more corporations or individuals, each with different responsibilities).

Keywords: Farm business organization, sole proprietorships, farm partnerships, farm corporations, Federal tax incentives, estate and gift taxes.

Washington, D.C. 20250 June 1981

Preface

This report describes the relative advantages of the three major forms of farm business organization—the sole proprietorship, the partnership, and the corporation. The major focus is on how Federal taxes and closely related incentives affect the different forms of business organization.

Change in the relative proportion of farm producers that use one or more of the available legal forms of farm business organization is becoming more important in analyzing the farm sector of our economy. Several Federal and State statutes and regulations influence farmers' choices, particularly where their businesses have grown in gross sales due both to increasing physical size of the business and to increases in product prices.

This report describes and analyzes several changes in statutes at the Federal level with particular emphasis on Federal income and estate taxation. State and local tax laws may likewise influence a farmer's choice of business organization, but State laws vary widely in their requirements and are beyond the scope of this report. Of course, farmers should understand and must comply with the appropriate State provisions and are urged to contact local tax attorneys and accountants, State extension agents, and State and local legislators for the most recent renderings of such laws and regulations.

Federal legislation to change the tax rate structure for individuals and corporations was moving forward in the Congress at the time this publication went to press. The most likely changes in tax rate structures and other provisions regarding deductions, although changing the specific results described herein, would not change the general conclusions. The Economics and Statistics Service is not regularly funded by the Congress to do extensive Federal tax analysis, and updating is not planned. Readers with questions are urged to contact their tax attorneys and accountants, their State experiment and extension services, the tax analysis offices in the U.S. Department of the Treasury, and the tax writing committees in Congress.

Acknowledgments

The authors acknowledge with thanks the comments and suggestions of Charles Davenport, Neil Harl, David Harrington, Harald Jensen, Donn Reimund, David Reinders, and Jeff Wegner.

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Summary

Federal tax laws encourage larger farm businesses to incorporate because larger incorporated firms generally pay lower tax rates than sole proprietorships or partnerships with the same taxable income. Those tax advantages, coupled with certain organizational advantages of an incorporated business, give larger farms (more than $25,000 to $30,000 of annual taxable income) compelling incentives to incorporate to maximize growth. Farmers seem to be aware of some of the advantages of incorporating, as the most recent census of agriculture shows that the number of incorporated farms nearly doubled between 1974 and 1978. Most of those new farm corporations were probably created by farmers, not by nonfarm investors.

This report compares three types of farm organization—sole proprietorship, partnership, and corporation—chiefly in regard to the income tax laws, but also in regard to other factors that influence the farmer's choice of business organization: the degree of personal control of the operator, limits on the farm's business activities, the ease of passing the farm intact to heirs and minimizing estate taxes, and the cost of fringe benefits offered by businesses to employees.

Larger corporations generally pay less in taxes than a partnership or sole proprietorship:

—The corporate tax rate was reduced twice during the seventies so that corporations with taxable income above the $25,000-$30,000 range are taxed at lower tax rates than formerly. Personal tax rates, however, were not reduced, which led to "bracket creep" for many farmers (and others) as inflation-induced increases in income put them into higher tax brackets.

—Incorporating allows the farmer to allocate income among the corporation and individual family members so that each will pay at the lowest possible income tax rate.

—A farmer with a farm corporation can adjust salary levels and timing of farm sales and purchases of farm inputs in order to minimize the total tax bill as long as the corporation is permitted to use cash accounting.

Besides reducing income taxes, other potential advantages of incorporating include:

—Making estate planning and asset transfer easier both during the farmer's lifetime and after death to enable the farm business to continue for more than one generation.

—Limiting the farmer's liability to the business assets that are owned by the corporation without exposing the farmer's personal assets that are not in the corporation.

—Helping preserve the farm when the owner dies by reducing Federal gift and estate taxes and encouraging nonfarm heirs to retain their interest and investment in the farm and be compensated for it.

—Allowing more flexibility in choosing tax-free fringe benefits—retirement plans, life insurance, and health insurance, for example.

—Allowing more flexibility in distributing income among family members through income-sharing arrangements to minimize the family's total tax bill.

Notwithstanding those attractions, incorporation has some drawbacks compared with sole proprietorships and partnerships:

—Long-term capital gains may be taxed at a higher rate.

—Social Security taxes are higher and a corporation may have to pay Workers' Compensation and Unemployment Insurance for employees, which a sole proprietorship or partnership need not do if only family members are employed by the business.

—The cost of formation (setting up the business) is generally greater for corporations than for sole proprietorships and partnerships.

While farmers with $25,000 or more of taxable income can probably reduce their Federal income taxes by incorporating, most of them have apparently not yet done so. Their reasons for continuing as sole proprietors are probably as varied as the individuals. For many farmers, the more complex bookkeeping and tax rules and regulations for corporations are unappealing. Many could probably spend that time more profitably on intensifying their efforts in familiar activities such as timing farm input purchases and sales better and improving crop-growing practices. Such farmers may, however, incorporate if the financial advantages warrant hiring accountants and attorneys to do the work for them, or if they can hire workers to do the farmwork while they devote their own time to accounting, financial and overall management, and entrepreneurial activities.

Based on eight simulated farm situations, incorporated farms that start with a net worth of over $600,000 are able to save an average of more than $100,000 in income taxes over a 10-year period compared with a sole proprietorship. The projected 10-year tax savings range from $68,000 for an Ohio soybean-corn farm to $197,000 for a Washington Palouse winter wheat farm. If the tax savings are reinvested in the farm business, the equity growth of the incorporated farm exceeds the equity growth of the sole proprietorship by even more than the tax savings.

If Federal income and estate transfer tax provisions continue to favor farm incorporation, more of the larger farms will likely incorporate. Most incorporated farms will probably continue to be run and controlled by farm families at least through the first generation of owners. A trend toward incorporation may, however, require scrutiny of other, more basic economic issues. For example, questions will arise over whether corporations are efficient in their use of resources, how severely the indefinite life of a corporate farm will limit the availability of agricultural land for rent or purchase, and whether farm corporations (which generally have larger credit and capital needs than sole proprietorships) will be able to satisfy their credit and capital needs from the traditional farm financing sector.

Economic and Federal Tax Factors Affecting the Choice of a Legal Farm Business Organization

Michael Boehlje
Kenneth Krause[1]

Introduction

Changes in the tax laws in the seventies, coupled with some tax-related effects of inflation, enhanced the advantage of corporations over sole proprietorships and partnerships for farmers with large taxable farm incomes. Those recent tax changes, although not specifically enacted for their effects on farms, nevertheless offer added inducements for farms, as well as other businesses, to incorporate.

Taxation of income, however, is only one factor among many in deciding on a legal farm business organization, and some of the others may, depending on each farm's circumstances, support or counterbalance the tax advantages of incorporating. Some of those factors include estate taxes, the liability of the operator, limits on the business activities of the farm, the life of the business, access to additional funds, organizational costs, and public disclosure of activities.

In this report, we describe the different types of farm business organizations, and the major factors that farmers should consider in organizing their farm businesses. In doing that, we offer general suggestions on the size of farm that can benefit most by incorporating, emphasizing those tax incentives (primarily Federal income and estate taxes) and other related incentives that encourage farmers to operate their businesses as corporations rather than as sole proprietorships. We also include an analysis of eight illustrative farms and how they are projected to fare over a 10-year period under a sole proprietorship organization and a corporate organization.

Our focus is limited to the production side of agriculture; little attention is given to the supply firms and marketing firms that may acquire farm production resources as part of a diversification or integration process. The primary motivations for such firms to be organized as partnerships or sole proprietorships are only partially related to their farming activities.

We expect that the farms most likely to respond to incentives to change their business organizations will be among the 800,000 largest farms (about 35 percent of the total) that produced 90 percent of the U.S. farm products in 1978. That group of farms does not include those where off-farm employment provides most of the household income. Smaller and part-time farmers also have incentives to incorporate, but the benefits, particularly from the income tax provisions, will not be as great as those for larger farms. For the very largest farms, owned by several families or by nonfarm owners, the information and analysis presented here are not particularly relevant. Such farm firms have more complex organizational, operational, ownership, and Federal income tax concerns than the family size operations that are the focus of this report.

The sole proprietorship and the corporate forms of business organization are given the most attention in this report. In 1978, the number of sole proprietor U.S. farms totaled 1,964,831—87 percent of total farm operations; partnerships and corporations totaled 10.3 and 2.3 percent, respectively, of U.S. farms.[2] The number of farm partnerships has declined slightly over the past decade. However, both general and limited partnerships will continue to be used, and at times their numbers may increase as opportunities arise for investors to engage in such

[1]Professor of Economics, Iowa State University, Ames, Iowa, and Agricultural Economist, National Economics Division, ESS, respectively.

[2]Farms in the census' "other" category made up the remaining 0.4 percent. Due to procedural changes in conducting the 1978 Census of Agriculture, the 1978 and 1974 numbers of "census farms" are not compatible. The 1978 numbers shown here were adjusted for compatibility with 1974.

Not for Preparing Tax Returns
We should introduce a caveat at this early stage, a caveat that is also repeated periodically through the report: farmers who may be inclined to change their organizational setup as a result either of our discussion or other reasons should seek expert advice from lawyers and tax advisors. The applicable laws and regulations are complex and errors can be costly.

ventures as occurred in the past in cattle feeding and vineyard development. In addition, informal partnerships between spouses or with children and farmer neighbors, which have long been a part of farming, will continue to be used. Such partnerships may increasingly use written agreements to document certain activities as their operations become larger and as partners become more concerned about formalizing their business organization to facilitate business expansion, estate transfer, and retirement planning.

Part I. Characteristics of Sole Proprietorships, Partnerships, and Corporations

Before changing the farm business from one legal organizational structure to another, or even before beginning a farm business, farmers should have a pretty clear idea of the relative advantages and disadvantages of each organizational type and be able to see how their final choice of farm organization will help them to meet their business and personal objectives. Farmers may choose one form of business organization (sole proprietorship, partnership, corporation) over another for a number of reasons. The choice depends in part on the characteristics of each type of organization and, equally important, on the particular situation, preferences, and objectives of the farmer. One type of organization may be best for one farmer's objectives while a neighbor with a similar farm and net worth may select a different form of organization.

The more important features of each organization are summarized in table 1 and discussed below:

- A sole proprietor owns and manages his or her own business; however, property used in the business may be owned by one or more people such as the husband, the husband and wife, or other family members.

- Two or more people contribute assets to a general partnership; share the management, profits, and losses; and are each liable for the actions of all partners to the extent of partnership activities. Many family farms are organized as partnerships between brothers or father and son (son-in-law) or daughter.

- Limited partnerships can also be used, generally to attract nonfarm investors as limited partners, whose liability is limited to their partnership shares.

- A corporation may be owned by one or more individuals, or other corporations and partnerships may own shares of stock in a corporation. A corporation is a separate legal entity and a separate taxpayer under tax regulations.

In some cases, the partnership is really a transition structure, a legal entity that will be used for a time until changes in the firm or the family necessitate changing to a sole proprietorship or a corporation. For example, a farmer with two children who want to farm may first form a partnership with the older child to help that child get started. Later, when the younger child is ready to start farming, a new partnership involving all three family members may be formed. Alternatively, a corporation may be formed to combine the resources of the family members, or the partnership may be dissolved and each child may form a sole proprietorship with assistance in the form of a loan from the parents.

For other farmers, helping a child establish a sole proprietorship may be an intermediate step to forming a partnership, or forming and operating a partnership may be an intermediate step to returning to a sole proprietorship, or the partnership may be continued indefinitely.

Formal and informal partnerships are also frequently formed for specified time periods when new technology becomes available that is too large or costly for one sole proprietor farmer to own and use alone.[3] Thus a partnership may be formed to purchase and operate new grain harvesting, handling, drying, storage and transport equipment or to produce or finish feeder livestock in specialized facilities. Such partnerships are not always among family members and the entire farm business may not be placed in the partnership. They are eventually dissolved as the technology changes or as the individual partners accrue enough wealth for each to own, rent, or hire his or her own technology.

Corporations are frequently referred to as publicly owned or closely held. Publicly owned corporations may have a few owners who reside in the local community or many shareholders worldwide. The stock in a public corporation is traded on an established market, such as a national or regional exchange or a local informal market, and shares can be transferred easily from sellers to buyers. Closely held corporations are controlled by a few individuals, frequently related, and the stock is not freely traded on a market; there may even be restrictions on who can own stock in the corporation. For example, in recent years, many family farmers have incorporated and restricted stock ownership to family members, thus forming closely held corporations.

[3]Joint ventures are also used, where farmers may own equipment or work together on a specific activity but each retains its own business identity and a partnership is not formed with a common profit goal.

Table 1—Selected characteristics of the general forms of business organization[1]

Nature of entity	Sole proprietor, single individual	General partnership[2], two or more individuals or corporations	Corporation[3], legal entity separate from shareholders
Life of business	Terminates when business is stopped or proprietor dies.	Agreed term: terminates at death of a partner or agreed succession.	Perpetual or fixed term of years if agreed to by owners and heirs.
Liability	Personally liable to full extent of personal assets.	Each partner liable for all partnership obligations of the firm and for actions of all partners.	Limited to personal investment. Shareholders not personally liable for corporate obligations unless they agree to be.
Source of capital	Personal investment, loans, gifts.	Partners' contributions, loans.	Shareholders' resource contributions for shares of stock, sale of stock, bonds, loans, retained earnings.
Management decisions	Individual, individual and spouse.	Agreement of partners or delegation by partners. Each has power to bind partnership.	Shareholders elect directors who appoint management.
Limits on business activity	Proprietor's discretion.	Agreed on by partners.	Articles of incorporation and State laws.
Transfer of interest	Terminates proprietorship.	Dissolves partnership; new partnership may be formed if all agree.	Transfer of stock may not affect continuity of business—may be transferred to outsiders if no restrictions imposed by charter.
Effect of death	Liquidation.	Liquidation or sale to surviving partners or agreed-on individual firm.	Stock passes by will or inheritance and corporation may continue to exist.
Federal income taxes	Income taxed to individual. Earned income taxed at a maximum of 50%. Capital gains maximum of 28%.	Partnership files an information return but pays no tax. Each partner reports share of income or loss, capital gains and losses as an individual. Salaries paid to partners are taxable to partners.	*Subchapter C Corporation* Corporation files a tax return and pays tax on income. Salaries to employees including shareholders are deductible. Capital gains offset by capital losses—maximum 28% capital gains rate. *Tax option, Subchapter S Corporation* Corporation files a tax return, but pays no tax. Each shareholder reports share of income, operating loss, and long-term capital gain.
Employee benefits	Only Social Security required.	Partnership pays no Social Security tax. Employees pay the same as sole proprietor. Other coverages can be purchased, some at group rates. None are tax deductible to partnership. Employees may set up Individual Retirement Accounts and deduct contributions up to $1,500 limit, or Keogh plan and deduct up to $7,500.	Social Security taxes of 6.13% in 1980 on the first $25,900 of earnings by both employees and corporation. May provide up to $50,000 of group term life insurance with no income tax consequences to employee. Employee health insurance may be available under group rates. Stockholder employees may qualify and in some States be required to be covered under Unemployment and Workers' Compensation, Retirement, and profit-sharing program contributions up to $32,700 may be deducted under a defined benefit program. Corporation's costs are deductible expenses.

[1]This table is a slightly revised version of that presented by Harl and O'Byrne (*14*)—see References at end of this report.

[2]Limited partnerships are a special form of partnership which have limited partners with limited liability and at least one general partner responsible for all partnership debts and obligations.

[3]Corporations may have one or more shareholders and shares may be bought and sold privately, or listed and bought on over-the-counter markets or the larger stock exchanges if the corporations meet certain qualifications. Bond issues may be likewise traded and, in addition, may be convertible to shares of voting or nonvoting stock. The corporation is incorporated in a particular State where it may or may not operate. Other farming activities of a parent corporation may be incorporated in different States. The corporate directors can elect, with Internal Revenue Service's approval, to file Federal income tax returns under regular corporate provisions, Subchapter C, and pay corporate rates, or, if 15 or fewer shareholders are involved, to be taxed as a Subchapter S corporation where owners report their individual shares of income and expenses and pay tax at personal rates.

Life of Business

By definition, a sole proprietorship ceases to exist when the proprietor stops doing business or dies. Partnerships are usually dissolved upon death of a partner, although provisions can be made for business continuity through an agreement among the partners.

One major reason for farms as well as other businesses to incorporate is to continue the business if the owner retires or dies. Business continuity supposedly results in more efficient use of resources since most businesses start out small and do not achieve most economies of size until later. As retirement nears, the farmer may reduce farm size and efficiency, often by dropping livestock or crop enterprises. It may be easier to integrate younger people into the management or ownership when the farm firm is at or near peak efficiency if the farm is organized as a corporation. By incorporating, the farm could continue indefinitely, particularly where younger persons are integrated into a business before the older manager's retirement or death. A surviving spouse also benefits from such an arrangement by receiving income from an ongoing efficient farm.

The key to business continuity however, is management depth, not the type of entity. Arrangements for the transition of a business to a new owner can be made for a sole proprietorship or partnership as well as for a corporation. When such arrangements are properly developed, long-range firm planning is facilitated, which in turn benefits the firm and its owners, and possibly society, because operators may be willing and able to adopt new, more efficient technology and modern management and financial practices. In some cases, more than one younger manager may be added and each of the managers may develop specialties, like crop or livestock production or buying, selling, and financing, that further enhance the overall efficiency of the firm.

Liability

A sole proprietor is personally liable for all business obligations, including direct financial liabilities as well as losses caused to others as a result of personal acts and damages or injury caused by business assets (machines, livestock). In a partnership, each partner is obligated for business liability to the extent of partnership activity as well as any personal acts undertaken in the name of the partnership. Limited partners in a limited partnership are liable only to the extent of their investment, so long as they are not employed by the partnership or participate in its management. Otherwise, the general partner(s) who has management responsibility and authority assumes full liability.

The corporate entity itself is fully liable for all its business obligations; individual shareholders are liable only to the extent of their investment. In practice, owners of closely held corporations often are required to guarantee personally the debts of their corporation. Furthermore, many farmers transfer almost all their assets, including their residence and automobile into the corporation, thus protecting few assets from creditors. Corporate officers and directors have increasingly been subject to shareholder liability claims for corporation mismanagement in recent years. Similar disputes may also arise among family members owning a farm corporation.

The size and types of liability claims that can be made against farmers make it almost imperative that a farmer buy liability insurance coverage, regardless of the form of business organization. Thus, the form of business organization is not a substitute for a formal comprehensive business and personal liability insurance program.

Source of Capital

Most farm businesses can obtain loans or credit from numerous sources: commercial and public lenders, merchants and dealers, and others. Loan terms and interest rates, within the limits of State usury laws, differ by lender and probably do not depend as much on form of business organization as on the business characteristics and credit repayment record of the borrower.

Financial institutions in some States in the past could not lend to sole proprietorships at a rate of interest higher than the usury rate, but they could lend to corporations at a higher rate because the usury law did not apply to corporate borrowers. Some sole proprietors, therefore, were encouraged to incorporate their farm businesses so the lender would not be subject to usury laws. This was the case in recent years as interest rates rose faster than usury ceilings. Farm lending institutions, such as the Farmers Home Administration (FmHA), were less likely to lend to farmers who are incorporated. However, because of changes in the late 1970's, FmHA has increasingly been making loans to farm corporations in recent years; particularly disaster and emergency operating loans.

The relative ease with which a corporate structure can maintain the capital base of the farm business as it is transferred to heirs is a very important feature. When a farm estate is transferred from owners to heirs, the equity of the farm can be eroded if nonfarm heirs are unwilling to hold their agricultural assets and sell those assets to someone other than the farming heir. However, a properly structured corporation can pay nonfarm heirs a competitive return on their inheritance, thus making them more willing to maintain their financial interest in the business. The income may be in the form of interest, if the heir owns debentures, or dividends, if stock is owned. In addition, buy-sell agreements may be written to restrict the sale of stock or specify the payment schedule for stock sales by nonfarm heirs. Thus, the equity capital of the firm will not erode as easily in this case, although the operating heir may own only part of the equity capital—the stock—of the firm.

Corporations and partnerships can also increase their equity capital base through the sale of stock or by adding partners, but the potential to raise substantial funds in that way is small for closely held businesses, whether farm or nonfarm.

Management Decisions

Sole proprietors are theoretically sole decisionmakers, while partners share decisionmaking in line with the partnership agreement. In a limited partnership, the general partner is responsible for operating as well as financing decisions. In a corporation, shareholders elect directors who are responsible for decisions. Directors elect officers who, in turn, are delegated operating authority with director review. In closely held corporations, the officer, director, and operating manager may be the same person. Thus, management decisions are made by one person or a small group of people in much the same way as in a sole proprietorship or partnership.

In large corporations, as well as in large limited partnerships, management personnel may be employees with limited, if any, ownership in the firm. There is a tendency for the larger partnerships and corporations also to make increasing use of specialized advisors and consultants: for example, accountants, attorneys, financial counselors, and soil, plant, and animal scientists. The smaller proprietorships, partnerships, and corporations can also use such specialists, but generally lack the volume of business to justify such employees or consultants. Instead, they have relied on assistance from such public sources as State experiment station personnel and the Cooperative Extension Service.

Loss of absolute control, which occurs in any multiowner arrangement like a partnership or corporation, may be an important factor in some farmers' business organization choices. For example, even though one person may retain majority voting control in a farm corporation, the requirement to consult with and inform other shareholders of decisions and results may outweigh the benefits of owning the firm jointly with others.

Limits on Business Activity

A sole proprietor supposedly has the greatest freedom to pursue any business activity, since the individual does not operate under a formal charter or agreement with other owners of the business. In reality, however, family members are often consulted by the sole proprietor and may jointly make decisions to engage in different types of activities. Informal partnerships possess most of the freedom of decisionmaking characteristics associated with sole proprietors.

Partnership and corporation activities are limited by the partnership agreement and articles of incorporation, respectively. Articles of incorporation are usually broadly written to permit many types of business activities. Financial limitations, agreements with lenders and landlords, as well as various government regulations often limit business activity regardless of the type of organization.

Some States have laws that limit the activities of corporations. North Dakota, for instance, has prohibited farming corporations for nearly 50 years. Another 10 States have placed certain restrictions on activities of farming corporations owned by U.S. citizens (*6*).[4] Since the midseventies, some States have placed restrictions on nonresident alien owners of corporations, partnerships, and even on sole proprietors engaged in farming.

[4]Italicized numbers in parentheses refer to sources cited in "References" at the end of this report.

Formation Costs and Recordkeeping

The cost of forming the legal entity and the records required to maintain that entity over time will vary depending upon the business organization and the State in which it is formed. The cost of establishing a sole proprietorship is minimal. A formal application is usually not required, just the normal records of any business to maintain financial control and to file appropriate tax returns. In some States, partnerships, particularly limited partnerships, must formally file for authorization to do business and file annual reports on their business activities. Corporations must obtain a State charter and frequently must file annual reports of business activity as well as tax reports. Attorney, accountant, and corporate charter fees may be as low as $1,000 or less but can be much larger, depending upon the filing requirements of the State.

In addition to the direct cost of formation, the indirect cost of time allocated to evaluate the advantages and disadvantages of the various legal entities can be substantial. An important but time-consuming activity is to develop an organizational plan to achieve the objectives of the business. A well developed plan provides for alternative courses of action as business and household conditions change, including contingency plans to accommodate unexpected events such as death of an owner-manager and changes in credit availability, tax laws, or other regulations affecting the legal status of the farm business.

The records required by a partnership or corporation are usually more detailed and complicated than those for a sole proprietorship, primarily because more detailed information is needed to account for the contributions of the various owners and the sharing of income among the partners or shareholders. In addition, a corporation must hold an annual business meeting, keep minutes and records of its activities, and specify policies concerning salaries and fees, dividends, and so forth. In some cases, a corporate farmer may need an accountant to keep the business records, project cash flows and credit needs, and file the proper tax and other reports. Although additional recordkeeping time and expenses may appear to be a disadvantage of corporations or partnerships, the additional records and documentation may be beneficial to the farmer in managing the business and maintaining control over the growth and expansion of the firm.

Requirements to provide certain financial information on corporate tax returns may be unappealing to farmers, who have traditionally kept their financial affairs private. Even more unappealing to some farmers in States that require various reports from corporations and partnerships, particularly limited partnerships, are the public disclosure and possible publicity that their activities might receive.

Income Sharing

The various forms of organization enable farmers to distribute income among family members in different ways and with different tax treatments. Sole proprietor farmers can pay wages to family members for services rendered; these expenditures are tax deductible farm expenses and taxable income to the family member. Where several children earn farm wages, the total family tax savings can be substantial. In 1979, each child could earn up to $2,300 without being required to pay Federal income or Social Security taxes, while the parents could deduct the wage payments from taxable income and still claim a $1,000 personal exemption for each child so long as they provide at least half of the child's support. Sole proprietors can also borrow funds from family members with the interest payments on borrowed money being tax deductible expenses. Rental arrangements between spouses or parents and children may also be used to transfer income and reduce taxes.

Partnership income depends upon the contribution of labor and capital resources of each partner and the income-sharing arrangement. Substantial flexibility exists in income-sharing arrangements, although the share of income received by each partner should be reasonably related to the contributions, whether of capital or services, to the business. Unless properly developed and modified to reflect changing resource contributions over time on the part of the various partners, a partnership's income-sharing arrangement can be a source of serious conflicts and inequities, as well as potential tax problems.

Corporations can distribute income through various techniques, including salaries, directors' fees, consulting fees, dividends on stock, and interest on debentures. Again, payments to shareholder-employees must be reasonable, that is, based on services rendered. But there is still substantial flexibility in sharing income among corporate shareholders, officers, and employees.

Taxes and Employee and Self-Employed Benefits

Payroll taxes and fringe benefits have become more important in farming as government has imposed broader, more costly taxes on employers and employees. In addition, farmers and their employees have become more aware of rising health and accident costs, and have sought insurance coverage as well as private retirement programs. Employee benefits, like insurance and retirement plans, are taxed differently depending upon the form of business organization. For example, certain insurance costs are tax deductible expenses for a corporation but not for a sole proprietorship. Thus, Federal tax treatment of income and permitted deductions for payroll and fringe benefit expenses differ by organizational structure and may provide an important incentive to change the form of business organization.

Part II. Differences in Federal Taxation of Business Entities

In addition to their differences in organizational features, different types of businesses are treated differently by the Federal tax laws—both in the tax rates and in the way that net taxable income is computed. Those tax differences should also be considered by farmers in deciding which type of organization is best for their needs. In this section, we discuss the major differences in tax treatments by type of business and the possible effects of those differences on the farm business. Besides tax rates and computation of taxable income, we discuss differences among other tax-related issues: in the handling of capital gains and losses; in the possibility of dividing income among separate entities on the farm or among members of the farm family in order to reduce income taxes; in the aftertax costs of payroll taxes (Social Security, Workers' Compensation, and Unemployment Insurance); in the aftertax costs of retirement plans, insurance plans, and health insurance plans; and in estate and gift taxes. Most of the ensuing comparisons are between a corporation and a sole proprietorship. Partnerships are seldom mentioned explicitly because, for most cases, partnership income is treated, for tax purposes, like sole proprietorship income.

Income Tax Rates and "Bracket Creep"

Taxation of income for the sole proprietorship differs considerably from that for the regularly taxed corporation.[5] Different tax rates apply to each, capital gains and losses are handled differently, and different deductions are allowed in determining taxable income.[6]

The 1979 Federal income tax rates for individuals (sole proprietors) and corporations are summarized in tables 2 and 3. A partnership files an information return only; it pays no Federal income tax. Instead, partnership income is allocated to the partners in the same form as it was earned by the partnership, that is, ordinary income, capital gain, and so forth. The partners report and pay tax on that income as individuals at personal tax rates.

A special form of the corporation, called the tax-option or Subchapter S corporation, can be used for tax purposes (chiefly for corporations with 15 or fewer shareholders). Income is allocated to the shareholders generally in the same form as earned by the corporation and is taxed at personal rates. The tax-option corporation is not itself a separate taxable entity.

Income taxes have become an increasingly important consideration in recent years in choosing a form of business organization for two key reasons: first, the net income (and income taxes) of many farming operations has been increasing because of inflation and growth in the size of farms; second,

Table 2—Federal personal income tax rates for married taxpayers filing jointly, 1979

Taxable income	Tax liability is	Plus[1]	Of income above
	Dollars	*Percent*	*Dollars*
$ 3,400–5,499	0	14	3,400
$ 5,500–7,599	294	16	5,500
$ 7,600–11,899	630	18	7,600
$ 11,900–15,999	1,404	21	11,900
$ 16,000–20,199	2,265	24	16,000
$ 20,200–24,599	3,273	28	20,200
$ 24,600–29,899	4,505	32	24,600
$ 29,900–35,199	6,201	37	29,900
$ 35,200–45,799	8,162	43	35,200
$ 45,800–59,999	12,720	49	45,800
$ 60,000–85,599	19,678	54	60,000
$ 85,600–109,399	35,502	59	85,600
$109,400–162,399	47,544	64	109,400
$162,400–215,399	81,464	68	162,400
$215,400 and over	117,504	70	215,400

[1]Earned income was subject to a maximum marginal rate of 50 percent in 1979. However, only part of the income from farming is considered to be personal service earned income and thus, subject to the maximum 50-percent tax on earned income. Prior to 1979, 30 percent of farm income was assumed to be earned or personal service and 70 percent was capital or other earnings. These rules were changed for tax years beginning in 1979; currently the rules require a "reasonable" allocation of farm income to personal services.

[5]Taxed at corporate rates under Subchapter C of the Internal Revenue Code (IRC). Some corporations, however, can elect to file under Subchapter S of the IRC, which allows the corporation's income to be treated much like that of a partnership. Hereafter, we refer to these latter corporations as tax option corporations.

[6]Several income tax provisions that have application in specific farm situations such as the minimum tax on preference income are not discussed. The general tax preferences long granted agriculture such as cash accounting can be used by all three business organizations and are not analyzed separately except where limitations are imposed on cash accounting for corporations and some partnerships with a corporation as a partner. State income tax treatment of each of the forms of business organizations can vary by State and may also influence the selection of a business organization. A discussion of the tax laws of each State, however, is beyond the scope of this report.

Table 3—Corporate Federal income tax rate schedule, 1979

Taxable income	Tax liability is	Plus	Of income above
	Dollars	*Percent*	*Dollars*
Less than $24,999	0	17	0
$ 25,000–49,999	4,250	20	25,000
$ 50,000–74,999	9,250	30	50,000
$ 75,000–99,999	16,750	40	75,000
$100,000 and over	26,750	46	100,000

corporate tax rates have been reduced. While there have been some adjustments in personal income tax deductions, most of which benefit taxpayers with low taxable incomes, inflation and higher nominal incomes have moved many farmers into higher personal income tax brackets. While estimates have not been made for farmers alone, Eckstein estimated that all noncorporate taxpayers will pay $14 billion additional Federal income taxes in 1981, due to inflation (5).

"Bracket creep," being taxed at higher marginal tax rates because tax rates have not been adjusted for inflation, is illustrated in table 4. For a $12,000 income in 1969 (equivalent to $23,760 in 1979 dollars), the marginal tax rate increased 13 percent or less.[7] For incomes between $14,000 and $35,000 in 1969 dollars ($27,720 and $69,300 in 1979 dollars), the marginal rate increased between 28 and 53 percent. For incomes of $40,000 and above in 1969 dollars ($79,200 and more in 1979 dollars), the rate increased less than 17 percent; in fact at the higher levels of income, the marginal tax rate declined between 1969 and 1979 because tax provisions were changed during this period to reduce the maximum marginal tax rate on earned income from 70 percent in 1969 to 50 percent in 1979. Thus, middle-income taxpayers earning between $14,000 and $35,000 in 1969 dollars saw their marginal tax rate increase dramatically between 1969 and 1979, whereas those with lower or higher incomes saw little change or even a decline in their marginal tax bracket.

Only part of the income from farming is considered to be personal service income and thus subject to the maximum 50-percent tax on earned income. The current tax rules require a "reasonable" allocation of farm income to personal services. (The interpretation of "reasonable" will probably be based, at least in part, on the regulation in effect before 1979, when the tax code was changed. Prior to 1979, 30 percent of farm income was assumed to be earned or personal service income and 70 percent was capital or other earnings.) For someone whose taxable income is 100-percent earned income and is thus not required to allocate income between personal services income and income from other sources, the maximum 50-percent tax on earned income is more beneficial than the numbers in table 4 indicate. For such a person, the marginal bracket above $60,000 of income in 1979 is only 50 percent. In this case the percentage change in the marginal tax bracket between 1969 and 1979 *declines* dramatically for 1979 income levels in excess of approximately $100,000.

Corporate tax rates were reduced twice during the seventies. Before 1975, the corporate rate was 22 percent of the first $25,000 of taxable income, and a 48-percent tax was imposed on all income above $25,000. For the years 1975 through 1978, the rate was reduced to 20 percent on the first $25,000 of taxable income, 22 percent on income between $25,000 and $50,000 and 48 percent on income above $50,000. Starting with 1979, the corporate tax rate was 17 percent for the first $25,000 of taxable income and increased to 20, 30 and 40 percent for each succeeding $25,000 of taxable income. Taxable income above $100,000 is taxed at 46 percent.[8]

Thus, in contrast to the "bracket creep" phenomenon for those who pay income taxes at personal income tax rates (that is, sole proprietors, partners, wage earners), the tax rates on corporations were substantially reduced from 1969 to 1979. For a corporate taxable income of $10,000 or less in 1969 dollars ($19,800 in 1979 dollars), the marginal tax rate declined by 23 percent from 1969 to 1979; for incomes between $30,000 and $40,000 in 1969 dollars ($59,400 and $79,200 in 1979 dollars), the

[7]1979 tax rates were used throughout the analysis in this manuscript since 1979 was the latest year for which the consumer price index was available when the analysis was made.

[8]The reductions were not considered by the Congress for their specific effects on farmers or farm structure, but to favor small businesses. In other sectors of the economy, a firm is considered small if it has an annual income of under $500,000. This is not yet the case in farming, but the effects of the rate changes may encourage a trend toward farm incorporation (33).

Table 4—Percentage changes in personal Federal income tax rate due to inflation and changes in tax provisions for married taxpayers filing jointly, with two children, 1969 and 1979

1969			1979			Change in marginal tax rate due to inflation and changes in tax provisions
Total income[1]	Taxable income[2]	Marginal tax rate[3]	Equivalent income adjusted for inflation[4]	Taxable income[5]	Marginal tax rate	
-------Dollars-----		Percent	--------------Dollars--------------			Percent
2,000	0	0	3,960	0	0	0
4,000	1,000	14	7,920	3,920	14	0
6,000	3,000	16	11,880	7,880	18	13
8,000	5,000	19	15,840	11,840	18	-.53
10,000	6,600	19	19,800	15,800	21	11
12,000	8,600	22	23,760	19,760	24	9
14,000	10,600	22	27,720	24,720	32	45
16,000	12,600	25	31,680	27,680	32	28
18,000	14,600	25	35,640	31,640	37	28
20,000	16,600	28	39,400	35,400	43	53
25,000	21,600	32	49,500	45,500	43	34
30,000	26,600	36	59,400	55,400	49	36
35,000	31,500	39	69,300	65,300	[6]52.8	35
40,000	36,600	45	79,200	75,200	[6]52.8	17
45,000	41,600	48	89,100	85,100	[6]52.8	10
50,000	46,600	50	99,000	95,000	[6]56.3	13
100,000	96,600	60	198,000	194,000	[6]62.6	4
150,000	146,000	66	297,000	293,000	[6]64.0	-3
200,000	196,000	69	396,000	392,000	[6]64.0	-7
250,000	246,000	70	495,000	491,000	[6]64.0	-9

[1]The amount of income that must be reported for tax purposes prior to deductions and exemptions.

[2]The 1969 personal exemption for husband and wife and each child was $600; thus, $2,400 was subtracted from total income. The 1969 standard deduction of 10 percent of adjusted gross income up to $1,000 maximum was also subtracted from total income.

[3]The rates shown in the Tax Rate schedules on individuals, corporations, estates and trusts, were used in the computations. A surcharge of 10 percent of the tax liability imposed for the January through December 31, 1969, period, and adjustments to it for small amounts of tax liability ($735 or less), and retirement income credit reduction were not included. This surcharge was imposed in 1969 as a means to raise revenue rather than as an attempt to alter the basic structure of the tax code. Furthermore, since the percentage surcharge increased the tax liability of all taxpayers in a constant proportion, it had no significant impact on the relative tax burden for taxpayers with different income levels.

[4]The equivalent income in 1979 was obtained by adjusting the 1969 income by the Consumer Price Index, 1969 was 109.8, 1979 was 217.4 (1967 = 100).

[5]The 1979 personal exemption for husband and wife and each child was $1,000; thus, $4,000 was subtracted from total income adjusted for inflation. The 1979 zero bracket amount of $3,400 for married taxpayers filing joint returns is built into the tax rate schedule.

[6]Earned income was subject to a maximum marginal rate of 70 percent in 1969, 60 percent in 1971, and 50 percent beginning in 1972. However, only part of the income from farming is considered to be personal service income and thus, subject to the maximum 50 percent tax on earned income. Prior to 1979, 30 percent of farm income was assumed to be earned or personal service and 70 percent was capital or other earnings. These rules were changed for tax years beginning in 1979; currently the rules require a "reasonable" allocation of farm income to personal services. Because the new rules have been in effect for only a short time, and do not provide a substantive base for dividing income between personal services income and other earnings, the rules in effect prior to 1979 (30 percent personal service or earned income, 70 percent other income) were used. Thus, any income above $60,000 in 1979 would be taxed at the 54 percent bracket if it were not subject to the maximum 50 percent rule on earned income. For example, at $65,300 of income, $5,300 is subject to the maximum tax on earned income rules, but only 30 percent of this income can qualify as earned income. Thus, the marginal tax bracket at this income level is calculated as: (.30 x .50) + (.70 x .54) = .528 or 52.8 percent.

marginal rate declined by 38 percent (table 5). The marginal tax rate for a specified constant real income increased for most sole proprietorships from 1969 to 1979, whereas it decreased for corporations during this same period.

The implications of these changes in tax rates between 1969 and 1979 for the corporation and sole proprietorship with respect to the tax liability for various levels of income are illustrated in table 6. For a 1969 income of between $10,000 and $300,000, bracket creep increased the tax liability as a percentage of the inflation-adjusted 1979 income for individuals and sole proprietorships. For income levels *below* and *above* this range, tax liabilities as a percentage of income are lower for equivalent real income in 1979 compared with 1969. A sole proprietor who earned $35,000 in 1969, for example, paid 23 percent of it in Federal income taxes; the 1979 equivalent income, in terms of purchasing power, was $69,300 and Federal income taxes amounted to 32.4 percent of that. By contrast, a sole proprietor with $6,000 of income in 1969 paid $450 in income tax (7.5 percent), assuming the taxpayer had four exemptions and took the standard deduction. On an equivalent 1979 income ($11,880), however, the taxpayer paid $680 (5.7 percent) in income taxes.

In contrast to the sole proprietorship, a corporation's tax liability as a proportion of income was lower in 1979 compared with 1969 for all levels of income if the salary, directors' fees, and interest were allocated to minimize the total tax liabilities. For example, with $20,000 of income in 1969 that could have been divided between the corporation and the owner, the total tax liability, corporate plus individual, would amount to $3,272 or 16.4 percent of income. An income of $39,400 was needed in 1979 to be equivalent in purchasing power to $20,000 of income in 1969. The total tax liability on $39,400 would have been $5,384 or 13.7 percent of

Table 5—Percentage decrease in corporation tax rate due to rate reduction and after inflation adjustment, 1969 and 1979

1969 taxable income[1]	Equivalent taxable income adjusted for inflation[2]	1969 marginal tax rate[3]	1979 marginal tax rate	Changes in marginal tax rate due to changes in tax provisions after accounting for inflation
Dollars		*Percent*		
2,000	3,960	22	17	-23
4,000	7,920	22	17	-23
6,000	11,880	22	17	-23
8,000	15,840	22	17	-23
10,000	19,800	22	17	-23
15,000	29,700	22	20	-9
20,000	39,600	22	20	-9
25,000	49,500	22	20	-9
30,000	59,400	48	30	-38
35,000	69,300	48	30	-38
40,000	79,200	48	40	-17
45,000	89,100	48	40	-17
50,000	99,000	48	40	-17
55,000	108,900	48	46	-4
60,000	118,800	48	46	-4

[1]Income reported and taxed at corporate income tax rates.
[2]The 1979 equivalent income was obtained by multiplying the 1969 income by 1.98, the amount of increase in the Consumer Price Index—1969 CPI was 109.8, 1979 CPI was 217.4 (1967 = 100).
[3]The 10-percent tax surcharge for individuals, corporations, estates, and trusts in 1969 was not included because it was a temporary provision with the primary purpose of raising revenue rather than changing the basic structure of the tax code.

Table 6—Minimum Federal income tax liability for a sole proprietorship versus an individual owner-manager and a corporation at various income levels, 1969 and equivalent 1979 income[1]

1969 total income[2]	Equivalent 1979 total income[2,3]	Sole proprietorship 1969 Total tax[4]	Sole proprietorship 1969 Tax as a percent of income	Sole proprietorship 1979 Total tax[5,6]	Sole proprietorship 1979 Tax as a percent of income	Individual owner-manager and corporation[7] 1969 Total tax	Individual owner-manager and corporation[7] 1969 Tax as a percent of income	Individual owner-manager and corporation[7] 1979 Total tax	Individual owner-manager and corporation[7] 1979 Tax as a percent of income
----------Dollars----------			Percent	Dollars	Percent	Dollars	Percent	Dollars	Percent
2,000	3,960	0	0	0	0	0	0	0	0
4,000	7,920	140	3.5	78	1.0	140	3.5	73	.9
6,000	11,880	450	7.5	680	5.7	450	7.5	678	5.7
8,000	15,840	772	9.7	1,393	8.8	772	9.7	1,351	7.2
10,000	19,800	1,114	11.1	2,223	11.3	1,114	11.1	2,024	10.2
12,000	23,760	1,512	12.6	3,167	13.3	1,512	12.6	2,697	11.3
14,000	27,720	1,874	13.4	4,543	16.4	1,874	13.3	3,340	12.1
16,000	31,680	2,385	14.9	5,491	17.3	2,392	15.0	4,044	12.7
18,000	35,640	2,910	16.2	6,845	19.2	2,832	15.7	4,717	13.2
20,000	39,400	3,428	17.1	8,248	20.1	3,272	16.4	5,384	13.7
25,000	49,500	4,892	19.6	12,571	25.4	4,372	17.5	7,374	14.9
30,000	59,400	6,596	22.0	17,520	29.5	5,472	18.2	9,354	15.7
35,000	69,300	8,036	23.0	24,760	32.4	6,572	18.8	11,368	16.4
40,000	79,200	10,610	26.5	27,703	35.0	7,672	19.2	13,935	17.6
45,000	89,100	12,908	28.7	33,030	37.1	8,928	19.8	16,905	19.0
50,000	99,000	15,360	30.7	38,586	39.0	10,392	20.8	19,875	20.0
55,000	108,900	17,860	32.5	44,160	40.1	11,992	21.8	22,951	21.1
60,000	118,800	20,498	34.2	49,923	42.0	14,004	23.3	26,752	22.5
65,000	128,700	23,148	35.6	55,843	43.4	16,100	24.8	30,712	23.9
70,000	138,600	25,740	36.8	61,763	44.6	18,408	26.3	34,672	25.0
75,000	148,500	28,490	38.0	67,683	45.6	20,808	27.7	38,911	26.2
80,000	158,400	31,368	39.2	73,603	46.5	23,208	29.0	43,426	27.4
85,000	168,300	34,268	40.3	79,639	47.3	25,608	30.1	47,980	28.5
90,000	178,200	37,100	41.2	85,836	48.2	28,008	31.1	52,534	29.5
95,000	188,100	41,400	42.3	92,033	49.0	30,408	32.0	57,088	30.3
100,000	198,000	43,140	43.1	98,230	49.6	32,808	32.8	61,642	31.1
150,000	297,000	74,736	49.8	161,280	54.3	56,808	37.9	107,182	36.1
200,000	396,000	108,634	54.1	224,640	56.0	80,808	40.4	152,722	38.6
250,000	495,000	143,600	57.4	288,640	58.3	185,542	46.0	198,262	40.1
300,000	594,000	178,600	59.5	352,000	59.3	231,082	46.0	243,262	41.0
400,000	792,000	248,600	62.2	478,720	60.4	322,162	46.0	334,882	42.3
500,000	990,000	318,600	63.7	605,440	61.2	413,242	46.0	425,962	43.0
1,000,000	1,980,000	768,600	76.8	1,239,040	62.6	868,642	46.0	881,362	44.5

[1]The details of the computation of total tax liabilities for the two business entity situations are provided in appendix table 1.

[2]The amount of income that must be reported for tax purposes prior to deductions and exemptions.

[3]The equivalent income in 1979 was obtained by multiplying the 1969 income by 1.98, the amount of increase in the Consumer Price Index—1969 CPI was 109.8, 1979 was 217.4 (1967 = 100)

[4]The 1969 personal exemption for husband and wife and each child was $600; thus $2,400 was subtracted from total income. The 1969 standard deduction of 10 percent of adjusted gross income up to $1,000 maximum was also subtracted from total income. The 10 percent surtax in 1969 was not subtracted.

[5]The 1979 personal exemption for husband and wife and each child was $1,000; thus $4,000 was subtracted from total income. The 1979 standard deduction of $3,400 for married taxpayers filing jointly is reflected in the tables.

[6]Maximum 50 percent earned income rules in effect prior to 1979 were used to calculate the effective tax rates on taxable income exceeding $60,000, e.g., 30 percent was assumed to be personal service or earned income and 70 percent other income and subject to higher rates.

[7]When a farmer forms a corporation, he in essence has developed a second tax entity for the business and has the opportunity to report all income as corporate income and pay tax at corporate rates or to pay tax-deductible salaries and other compensation to himself and his family for services rendered and thus report part of the income as corporate income (taxed at corporate rates) and part as salary or other compensation (taxed at personal rates). Most farmers draw a salary from the corporation to cover family expenditures so it is not reasonable to assume that all income is reported for tax purposes at the corporate rate. Consequently, we assumed that salaries and/or compensation would be set and income reported by the corporation and the individual owner-manager in such a fashion as to equate marginal tax brackets of the two taxable entities. IRS regulations require that such compensation be "reasonable" and based on services rendered.

income if the income were allocated between the corporation and the manager to minimize the total personal and corporate taxes.

The principle used in allocating income was to equate the marginal tax brackets between the taxpaying entities (table 7). Since differences in bracket structure between the corporate and personal tax rate made it impossible to equate the brackets exactly, the maximum amount of income was allocated to the taxpaying entity in the lower bracket. For example, at a $70,000 income, $50,000 is allocated to the corporation and taxed in the 20-percent marginal bracket and the remaining $20,000 is allocated to the owner-manager and taxed at the 21-percent marginal bracket. If an additional dollar of income had been kept in the corporation, rather than paid to the owner-manager, it would have been taxed at 30 percent, since the corporate tax rate increases from 20 to 30 percent for income above $50,000. Thus, the total tax bill would have increased by 9 cents per dollar; the marginal tax rate would have increased by 43 percent. Some farmers may want to receive more salary than the amounts shown in table 7; note, however, that at the lower income levels (up to approximately $10,000), all the income goes to the owner-manager in the form of salary and that the salary at higher incomes would allow at least a moderate standard of living in relation to the level of taxable income. Furthermore, as we note later, it may be possible to have the corporation pay directly some of the housing, food, and other expenses of the owner-manager from corporate income with such expenses being tax deductible to the corporation and not reportable as income by the owner-manager.

In practice, there is considerable flexibility in allocating income between the corporation and individual owner-manager, through appropriate setting of salaries, directors' fees, consulting fees, interest, rents, and other forms of compensation that are tax deductible to the corporation. Internal Revenue Service regulations do require, however, that such compensation must be "reasonable" and based on services rendered.

With a 1969 income of $20,000, a corporate farm would have payed $156 less in taxes than a sole proprietorship (table 6). For the same real income in 1979, the corporation would have payed $2,864 less in Federal income taxes than a sole proprietorship. At $50,000 of 1969 income, corporate taxes were $4,968 lower than those of a sole proprietor; for an equivalent 1979 income ($99,000), corporate taxes were $18,711 lower.

In summary, the data in table 6 indicate that although taxes increased in absolute terms from 1969 to 1979 for both the sole proprietorship and corporation, taxes as a proportion of real income *declined* for the corporation but *increased* for sole proprietorships with 1969 incomes between $10,000 and $300,000 (1979 incomes between $19,800 and $594,000). Thus, reductions in the income tax rates for corporations in combination with "bracket creep" in the personal rate schedule have provided an incentive for farmers to incorporate, particularly those with net incomes above $20,000 in 1979.

Income Sharing and Multiple Entities

Farmers may use several business entities simultaneously to own and operate their farm operations in order to lower total taxes and accomplish other business objectives. A farmer might, for example, include livestock and crop production enterprises in an operating corporation and own the land as an individual, renting it to the corporation under a cash or share leasing arrangement. As a sole proprietor, the farmer would probably use January 1 to December 31 as the tax accounting year. The corporate tax year, however, might be set to end March 31 or October 31 to reflect a farm production cycle. Through the proper specification of salaries and timing of the payment of salaries or purchases and sales of inventories, the farmer can adjust the taxable income of each taxpaying entity to minimize the total tax bill. Other payments that can be used to allocate income among various taxpaying entities include directors' and consulting fees, interest payments, and rent.[9] However, multiple entities should be structured with care, particularly if a landholding corporation is used. Tax problems such as recapture of investment credit, a 70-percent personal holding company tax and qualification for installment payment of Federal estate tax and special use valuation may be encountered (13).

[9]If a family chooses to use two or more corporations in their farming operations, they should be structured with care and expert legal counsel. If there is no compelling economic reason for two separate corporate entities and the entities are owned and controlled by family members, the IRS may invoke the family attribution rules and require the income of the corporations to be combined and taxed as one entity. However, multiple corporations may be a legitimate means of separating ownership, risk, or management for various enterprises or family members.

Table 7—Minimum Federal income tax liability for a corporation and its owner-manager, by income, 1979[1]

Income[2]	Individual owner-manager: Income[3,4]	Taxable income[5]	Marginal tax bracket	Total tax	Corporation: Taxable income[6]	Marginal tax bracket	Total tax	Total individual and corporation tax	Tax as a percent of total income
Dollars[6]			Percent	Dollars		Percent	Dollars		Percent
4,000	4,000	0	0	0	0	0	0	0	0
8,000	8,000	4,000	14	84	0	0	0	84	1.1
12,000	11,600	7,600	16	630	400	17	28	658	5.5
16,000	11,600	7,600	16	630	4,400	17	748	1,378	8.6
20,000	11,600	7,600	16	630	8,400	17	1,428	2,058	10.3
25,000	11,600	7,600	16	630	13,400	17	2,278	2,908	11.6
30,000	11,600	7,600	16	630	18,400	17	3,128	3,758	12.5
35,000	11,600	7,600	16	630	23,400	17	3,978	4,608	13.2
40,000	15,000	11,900	18	1,242	25,000	17	4,250	5,492	13.7
45,000	15,900	11,900	18	1,404	29,100	20	5,070	6,474	14.4
50,000	15,900	11,900	18	1,404	34,100	20	6,070	7,474	14.9
55,000	15,900	11,900	18	1,404	39,100	20	7,070	8,474	15.4
60,000	15,900	11,900	18	1,404	44,100	20	8,070	9,474	15.8
65,000	15,900	11,900	18	1,404	49,100	20	9,070	10,474	16.1
70,000	20,000	16,000	21	2,265	50,000	20	9,250	11,515	16.5
75,000	25,000	21,000	28	3,497	50,000	20	9,250	12,747	17.0
80,000	28,600	24,600	28	4,505	51,400	30	9,670	14,175	17.7
85,000	28,600	24,600	28	4,505	56,400	30	11,170	15,675	18.4
90,000	28,600	24,600	28	4,505	61,400	30	12,670	17,175	19.1
95,000	28,600	24,600	28	4,505	66,400	30	14,170	18,675	19.7
100,000	28,600	24,600	28	4,505	71,400	30	15,670	20,175	20.2
105,000	30,000	26,000	37	4,953	75,000	30	16,750	21,703	20.7
110,000	35,000	31,000	37	6,608	75,000	30	16,750	23,358	21.2
115,000	39,200	35,200	37	8,162	75,800	40	17,070	25,232	21.9
120,000	39,200	35,200	37	8,162	80,800	40	19,070	27,232	22.7
125,000	39,200	35,200	37	8,162	85,800	40	21,070	29,232	23.4
130,000	39,200	35,200	37	8,162	90,800	40	23,070	31,232	24.0
135,000	39,200	35,200	37	8,162	95,800	40	25,070	33,232	24.6
140,000	40,000	36,000	43	8,505	100,000	40	26,750	35,256	25.2
145,000	45,000	41,000	43	10,656	100,000	40	26,750	37,406	25.7
150,000	49,800	45,800	43	12,720	100,200	46	26,842	39,562	26.4
200,000	45,800	45,800	43	12,720	150,200	46	49,842	62,562	31.3

[1]Total income is allocated between the individual owner-manager and the corporation so as to minimize the total tax bill. The principle used in this allocation was to equate the marginal tax brackets between the taxpaying entities. Since differences in bracket structure between the corporate and personal tax rate made it impossible to equate the brackets exactly, the procedure used was to maximize the amount of income allocated to the taxpaying entity with the lower bracket. For example, at the $70,000 income level, $50,000 of income is allocated to the corporation and taxed at the 20-percent marginal bracket and the remaining $20,000 is allocated to the owner-manager and taxed at the 21-percent marginal bracket. If an additional dollar of income had been allocated from the owner-manager to the corporation, it would have been taxed at 30 percent (the corporate tax rate increases from 20 to 30 percent for income above $50,000), thus increasing the marginal tax rate by 43 percent. In practice, the allocation between the corporation and individual owner-manager can be accomplished by appropriate setting of salaries, directors' fees, and other forms of compensation. IRS regulations require that such compensation be "reasonable" and based on services rendered.

[2]The amount of income reported for tax purposes prior to deductions and exemptions.

[3]Income reported and taxed at individual income tax rates.

[4]The amount of income allocated to the owner-manager in relation to the total available for allocation may appear low; however, the owner-manager may not need or want more income that would be taxed at a higher rate, particularly where some otherwise personal expense items are paid for by the corporation and are not considered as taxable income to the owner-manager but are deductible corporate expenses.

[5]The 1979 personal exemption for husband and wife and each child was $1,000; thus $4,000 was subtracted from total income. The 1979 standard deduction of $3,400 for married taxpayers filing joint returns is reflected as the zero bracket amount in the IRS table.

[6]Income reported and taxed at corporate income tax rates.

The opportunity to use various combinations of business entities to reduce the total Federal income tax liability is illustrated in table 8. The principles noted earlier to minimize the tax bill by equating, if possible, the marginal tax rates were used to allocate income among the various taxpaying entities. The first two columns of table 8 summarize the tax liabilities for a sole proprietorship and a combination corporation and owner-manager. For all income levels, the tax liability is the same or lower for the corporation-manager combination; for incomes below approximately $10,000, taxes are the same for the two organizations because all the income in the corporation manager combination is reported and taxed at individual rates. Above $10,000, the income-splitting potential of the corporation-manager combination plus the lower corporate tax rates reduce the total tax liability. The differences in tax liabilities are substantial for incomes of $30,000 or more; for example with an income of $50,000, the tax savings of the corporation-individual combination amounts to $5,344. At an income level of $100,000, the tax savings of the combination is $18,875 and it consistently increases as income rises. For income between $50,000 and $250,000, taxes as a percentage of income are at least 10 percentage points lower (in some cases almost 20 points lower) for the corporation-individual combination than for the sole proprietorship.

In many family situations, two family members, such as a husband and wife or father and son (or son-in-law or daughter) are active participants in the farming operation. The third column of table 8 indicates the tax liability when the farm business includes three taxpaying entities, two owner-managers and a corporation.[10] Note that for a $60,000 income, the tax bill for the multiple manager-corporation combination amounts to $7,698, 12.8 percent of total income, compared with 29.5 percent for a sole proprietorship. If a corporation were not used and the $60,000 of income were split equally between the two owner-managers and taxed at personal rates, each would pay $4,953 of tax (the personal tax on $30,000 of income) for a total tax bill of $9,906. Thus, the multiple manager-corporation structure saves $2,208 in Federal income taxes compared with two sole proprietors or a partnership in which income is divided equally between the partners and taxed at personal rates. For an income level of $100,000, the tax savings of the multiple manager-corporate structure amounts to $9,412 ($12,818 x 2 - $16,244) compared with two sole proprietorships or a partnership; for $200,000 of income, the savings amounts to $25,726. This savings continues to increase with increasing incomes.

[10]The tax-minimizing strategy noted earlier was used to allocate income among the taxpaying entities. This procedure may not be acceptable if one of the owner-managers has large personal debt obligations to service, wants a better standard of living, or is contributing a disproportionately large share of the resources to the corporation.

Deductions, Gains, Losses

Various other tax provisions may influence the choice of a business organization, particularly the choice between a sole proprietorship and a regularly taxed corporation. As noted earlier, a corporation pays Federal income taxes on its net taxable income. Income in excess of taxes is available for distribution to shareholders or to reinvest in the firm. With the exception of the $200 dividend exclusion for married couples filing jointly ($400 in 1981 and thereafter), dividends paid by a corporation to individuals are taxed a second time. Farm corporations frequently avoid the double taxation by not paying dividends, especially where the owners receive sufficient household income from salaries or officers' and directors' fees. Also, the tax option corporation may be used where the double taxation of dividends is an issue and other considerations favor the features provided by the Subchapter S corporation. Of course, the corporate income tax rates do not apply when the Subchapter S tax option is elected.

Dividends received by one corporation from another corporation, however, receive different Federal income tax treatment than dividends paid to individual shareholders. In most cases, 85 percent of the dividend income received by one corporation from another corporation is not subject to taxation. For a corporation in the 17-percent corporate tax rate bracket, the effective tax on dividends received is only 2.55 percent, while the effective rate is 6.9 percent for a corporation whose income is taxed at the maximum 46 percent rate. However, dividends from cooperatives that have not paid Federal tax on their income and from Subchapter S corporations do not qualify for the 85 percent exclusion.

Most sole proprietorships, partnerships, and family corporations can use the cash method of accounting to determine their income tax liability. The Tax Reform Act of 1976 requires corporations with annual gross receipts over $1 million to use an accrual method of accounting and to capitalize preproduc-

Table 8—Minimum Federal income tax liability and taxes as a percentage of total income, four business entity combinations, 1979[1]

Total income[2]	Total tax liability[3]							
	1 sole proprietor		1 individual owner-manager and 1 corporation		2 individual owner-managers and 1 corporation		2 individual owner-managers and 2 corporations[4]	
Dollars	*Dollars*[5]	*Percent*	*Dollars*[6]	*Percent*	*Dollars*[6]	*Percent*	*Dollars*[6]	*Percent*
4,000	0	0	0	0	0	0	0	0
8,000	84	1.1	84	1.1	0	0	0	0
12,000	702	5.9	658	5.5	0	0	0	0
16,000	1,425	8.9	1,378	8.6	168	1.1	168	1.1
20,000	2,265	11.3	2,058	10.3	748	3.7	748	3.7
30,000	4,953	16.5	3,758	12.5	3,266	7.7	2,316	7.7
40,000	8,506	21.3	5,492	13.7	4,966	10.3	4,116	10.3
50,000	12,818	25.6	7,474	14.9	5,734	11.5	5,541	11.1
60,000	17,718	29.5	9,474	15.8	7,698	12.8	7,516	12.5
70,000	22,846	32.6	11,515	16.5	9,698	13.9	9,216	13.2
80,000	28,126	35.2	14,175	17.7	11,698	14.6	10,984	13.7
90,000	33,420	37.1	17,175	19.1	13,780	15.3	12,948	14.4
100,000	39,050	39.1	20,175	20.2	16,244	16.2	14,948	14.9
110,000	44,680	40.6	23,358	21.2	19,100	17.3	16,948	15.4
120,000	50,541	42.1	27,232	22.7	22,100	18.4	18,948	15.8
130,000	56,521	43.4	31,232	24.0	25,100	19.3	20,948	16.1
140,000	62,501	44.6	35,256	25.2	28,256	20.2	22,930	16.4
150,000	68,481	45.7	39,562	26.4	31,816	21.2	25,494	17.0
160,000	74,461	46.5	44,162	27.6	35,714	22.3	28,350	17.7
170,000	80,514	47.4	48,762	28.9	39,714	23.4	31,350	18.4
180,000	86,774	48.2	53,362	29.6	43,762	24.3	34,350	19.0
190,000	93,034	49.0	57,962	30.5	48,062	25.3	37,350	19.7
200,000	99,294	49.6	62,562	31.3	52,374	26.2	40,350	20.2
250,000	131,022	52.4	85,562	34.2	75,374	30.1	58,464	23.4
300,000	163,022	54.3	108,562	36.2	98,374	32.8	78,940	26.3
350,000	195,022	55.7	131,562	37.6	121,374	34.7	102,124	29.2
400,000	227,022	56.8	154,562	38.6	144,374	36.1	125,124	31.3
450,000	259,022	57.6	177,562	39.5	167,374	37.2	148,124	32.9
500,000	291,022	58.2	200,562	40.1	190,374	38.1	171,124	34.2
1,000,000	611,022	61.1	430,562	43.1	420,374	42.0	401,124	40.1

[1]The procedure used to allocate income among the various taxpaying entities included in each combination is the same as that used in tables 6 and 7: total income was allocated between the individual owner-manager(s) and the corporation so as to minimize the total tax bill. The principle used in this allocation was to equate the marginal tax brackets between the taxpaying entities. Since differences in bracket structure between the corporate and personal tax rate made it impossible to equate the brackets exactly, the procedure used was to maximize the amount of income allocated to the taxpaying entity with the lowest bracket. For example, in the case of one individual owner-manager and one corporation, at the $70,000 level, $50,000 of income is allocated to the corporation and taxed in the 20 percent marginal bracket and the remaining $20,000 is allocated to the owner-manager and taxed at the 21 percent marginal bracket. If an additional dollar of income had been allocated from the owner-manager to the corporation, it would have been taxed at 30 percent (the corporate tax rate increases from 20 to 30 percent above $50,000) thus increasing the marginal rate by 43 percent. In practice, the allocation between the corporation and individual owner-manager can be accomplished by appropriate setting of salaries, directors' fees, and other forms of compensation. IRS regulations require that such compensation be "reasonable" and based on services rendered.

[2]The amount of income reported for tax purposes prior to deductions and exemptions.

[3]The total taxes that must be paid for each combination of taxpaying entity.

[4]If a family chooses to use two or more corporations in their farming operations, they should be structured with care and expert legal counsel. If there is no compelling economic reason for two separate corporate entities and the entities are owned and controlled by family members, the IRS may invoke the family attribution rules and require the income of the corporations to be combined and taxed as one entity. However, multiple corporations may be a legitimate means of separating ownership, risk, or management for various enterprises or family members.

[5]Maximum 50-percent earned income rules in effect prior to 1979 were used to calculate the effective tax rates on taxable income exceeding $60,000, e.g., 30 percent was assumed to be personal service or earned income and 70 percent other income and subject to higher rates.

[6]The amount of income above the $20,000 income level allocated to the owner-managers in relation to total available income for allocation may appear low; however, the owner-manager may not need or want more income that would be taxed at a higher rate, particularly where some otherwise personal expense items are paid for by the corporation and are not considered as taxable income to the owner-manager but are deductible corporate expenses.

tive period expenses such as land preparation and fertilization; the same provisions apply to partnerships with a corporation as a partner. The exceptions to that provision are:

- Subchapter S corporations,
- Family corporations with at least 50 percent of the stock owned by members of a family,
- Family corporations in existence on October 4, 1976, where members of two families own, directly or indirectly, at least 65 percent of the stock,
- Corporations where three families own at least 50 percent of the stock and substantially all the rest is owned by employees, their families, or tax exempt employee's trusts,
- Nurseries.

A disincentive to incorporating is that corporate operating losses cannot be passed through to individual shareholders to offset taxable income. Such losses, however, can be passed through to the individual with the tax option (Subchapter S) corporation and they can be carried forward to offset future taxable income in regularly taxed corporations.

Farmers frequently put all of their assets into a corporation at the time of incorporation but may at a later date want some of them for personal use such as to build or buy a retirement home. When setting up a corporation, a farmer can contribute assets that have appreciated in value without incurring capital gains tax, if the contribution is handled properly. The basis (cost plus improvements less depreciation) of the assets in the corporation is the same as the basis for the transferer. If such assets, however, are later sold to a shareholder or anyone else, the corporation will be liable for a capital gains tax on the full amount of increase in value above the basis of those assets. If an individual shareholder purchases the assets and in the process sells or redeems shares of the corporation to buy the assets, he or she may have a long- or short-term capital gain or loss on the shares of stock sold, or may even have to report the proceeds of the sale as ordinary income. As a general rule of thumb, farmers may want to keep some assets out of the corporation for retirement or other purposes.

Only 40 percent of long-term capital gains are taxed for a sole proprietorship regardless of the tax rate brackets; for a sole proprietorship in the 32-percent bracket, the effective tax rate on capital gains is 12.8 percent. The full capital gain must be reported for tax purposes by a corporation, but the maximum rate is 28 percent on long-term capital gains. Capital losses cannot be passed through to individual shareholders by a corporation, regardless of whether it is taxed as a regular corporation or files under tax option provisions.[11] In addition, an individual taxpayer can deduct $3,000 of net short-term capital losses, or half of up to $6,000 in long-term capital losses, from other taxable income; such a deduction is not available to a corporation. A corporation, like an individual, can carry capital losses forward to offset capital gains in future years.

Current Federal income tax law allows a deduction for "additional first-year depreciation." Corporations receive less favorable tax treatment on additional first-year depreciation than sole proprietors. A corporation is limited to an additional 20 percent first-year depreciation on a maximum of $10,000 of property. Taxpayers filing a joint return may deduct 20 percent of up to $20,000 for a maximum deduction of $4,000 for additional first-year depreciation, while an individual filing a separate return has the same limits as a corporation. Thus, a taxpayer filing a joint return can claim a deduction of up to $2,000 more of additional first-year depreciation than can a corporation or an individual filing separately. Such a deduction would reduce taxes by $640 for a joint return in the 32-percent tax bracket.

Corporations are not permitted to deduct personal and nonbusiness expenses such as medical expenses that individuals can deduct. This limitation may create added tax costs for individuals who own a corporation and have high personal deductions such as medical expenses but do not receive sufficient salary and dividend income from their corporate employment to offset the permitted deductions. However, corporations can deduct the cost of medical insurance and other similar benefits provided for employees under certain circumstances.

[11]Capital losses should not be confused with ordinary operating losses, which a tax option corporation can pass through to shareholders. Regularly taxed corporations, however, cannot pass either capital or ordinary losses through to shareholders.

Social Security

Although a corporation may pay lower Federal income taxes than a sole proprietorship or partnership, payroll taxes, including Social Security, Unemployment Insurance, and Workers' Compensation, may be higher for a corporation. The Social Security tax rates for 1979 were 8.1 percent on the first $22,900 of earnings for self-employed individuals including partners. For a corporation or for any employee of a sole proprietorship or partnership, the rates were 6.13 percent contributed by the employee and the same percentage contributed by the employer for a total tax of 12.26 percent on the first $22,900 of employee salary. The Social Security rates and maximum earnings to which these rates apply are scheduled to increase in future years as summarized in table 9.

If a sole proprietor changes the business organization to a corporation and becomes an employee of that corporation, he or she must pay Social Security tax at the higher rates applicable to employers and employees. However, the share of this tax paid by the corporation is deductible in determining the corporate income tax liability. For a given level of income in a sole proprietorship or salary in a corporation, the Social Security taxes will always be higher with the corporate structure even after adjusting for the tax deductibility of the corporate contribution. The after-tax cost of the corporate contribution (6.13 percent of salaries and wages) is 3.31 percent for a corporation in the 46-percent tax bracket. When added to the owner-employee's contribution of 6.13 percent, the total after-tax cost of Social Security for such a corporation is 9.44 percent of salaries and wages compared with 8.1 percent for the sole proprietor.

However, as noted in the earlier discussion of income taxes, proper allocation of income between the corporation and owner-employee may result in substantial income tax savings. Table 10 indicates the Social Security taxes due for different levels of income if the income tax minimization strategy discussed earlier is used to determine the salary of the corporate owner-employee. No attempt was made in the calculations of table 10 to maximize potential

Table 9—Social Security minimum and maximum earnings and contributions, 1978–81

Year	Maximum earnings[1]	Contribution rate[2]		Maximum contribution		
		Self-employed	Employer and employee[3]	Self-employed[4]	Employer and employee[3,5]	Employer and employee total[6]
	Dollars	*Percent*		*Dollars*		
1978	17,700	8.10	6.05	1,433.70	1,070.85	2,141.70
1979	22,900	8.10	6.13	1,854.90	1,403.77	2,807.54
1980	25,900	8.10	6.13	2,097.90	1,587.67	3,175.34
1981	29,700	9.30	6.65	2,762.10	1,975.05	3,950.10

[1]Maximum earnings are projected by the Social Security Administration to increase from $31,800 in 1982 to $42,600 in 1987.

[2]Contribution rates are projected by the Social Security Administration to increase from 9.35 percent in 1982 to 10.75 by 2000 for self-employed individuals and from 6.70 percent in 1982 to 7.65 percent by 2000 for employers and employees.

[3]Employee and employer each contribute up to the maximum earnings.

[4]Self-employed contributions are not deductible against other income for Federal income tax purposes.

[5]Employer's contributions are tax deductible against other income for Federal income tax purposes. Where the employer pays the employee contribution, the amount of such contribution is taxable income to the employee.

[6]If a person has income from wages as well as self-employment, wages count first for coverage. If wages total less than the maximum earnings covered in a year, the self-employment contribution is paid only on the difference between the amount of wages and the amount of self-employed income up to the maximum earnings. Net losses from self-employment may be deducted from employee income.

Table 10—Social Security payroll tax after Federal income tax, sole proprietor versus individual owner-manager and corporation, by income levels, 1979

Total income[1]	After-tax Social Security cost		Social Security tax cost savings	Social Security tax cost as a percent of earned income	
	Sole proprietor[2]	Individual owner-manager and corporation[3]	Individual owner-manager versus sole proprietor	Sole proprietor	Individual owner-manager and corporation
	Dollars			Percent	
4,000	324.00	490.20	-166.20	8.1	12.3
8,000	648.00	930.40	-232.40	8.1	12.3
12,000	972.00	1,301.28	-339.28	8.1	10.8
16,000	1,296.00	1,301.28	-5.28	8.1	8.1
20,000	1,620.00	1,301.28	381.72	8.1	6.5
25,000	1,854.90	1,301.28	552.62	8.1	5.2
30,000	1,854.90	1,301.28	552.62	6.2	4.3
35,000	1,854.90	1,301.28	552.62	5.3	3.7
40,000	1,854.90	1,682.69	172.21	4.6	4.2
45,000	1,854.90	1,754.41	99.49	4.1	3.9
50,000	1,854.90	1,754.41	99.49	3.7	3.5
55,000	1,854.90	1,754.41	99.49	3.4	3.2
60,000	1,854.90	1,754.41	99.49	3.1	2.9
65,000	1,854.90	1,754.41	99.49	2.9	2.7
70,000	1,854.90	2,206.90	-351.90	2.6	3.1
75,000	1,854.90	2,526.79	-671.89	2.5	3.4
80,000	1,854.90	2,386.41	-531.51	2.3	3.0
85,000	1,854.90	2,386.41	-531.51	2.2	2.8
90,000	1,854.90	2,386.41	-531.51	2.1	2.6
95,000	1,854.90	2,386.41	-531.51	2.0	2.5
100,000	1,854.90	2,386.41	-531.51	1.9	2.4
105,000	1,854.90	2,386.41	-531.51	1.8	2.3
110,000	1,854.90	2,386.41	-531.51	1.7	2.2
115,000	1,854.90	2,246.03	-391.13	1.6	2.0
120,000	1,854.90	2,246.03	-391.13	1.5	1.9
125,000	1,854.90	2,246.03	-391.13	1.5	1.8
130,000	1,854.90	2,246.03	-391.13	1.4	1.7
135,000	1,854.90	2,246.03	-391.13	1.4	1.7
140,000	1,854.90	2,246.03	-391.13	1.3	1.6
145,000	1,854.90	2,246.03	-391.13	1.3	1.5
150,000	1,854.90	2,161.81	-306.91	1.2	1.4
200,000	1,854.90	2,161.81	-306.91	.9	1.1

[1]Total income is assumed to be earned income—the amount on which Social Security tax was calculated for the sole proprietor as well as the amount reported for tax purposes prior to deductions and exemptions. Social Security tax costs are not deductible on self-employed earnings.

[2]In 1979, a sole proprietor was taxed at 8.1 percent of earned income between $400 and $22,900. It was assumed that the sole proprietor received no off-farm income subject to Social Security tax.

[3]Income was divided between the corporation and the individual in the same manner as used in tables 6 and 7. In 1979, an employee and his or her employer were each taxed at 6.13 percent of wages or salary up to $22,900. The employer is required to pay Social Security taxes on wages and salaries paid to an employee, but is able to deduct such taxes from taxable income.

Social Security benefits by paying the maximum salary possible to the owner-employee; we assumed that minimizing current taxes was more important than obtaining larger Social Security benefits in the future. Furthermore, the earnings subject to Social Security tax are different for the sole proprietorship and corporation for a given level of income (table 10). Note that under these conditions, the Social Security tax as a percentage of earned income is higher for the corporation than for the sole proprietorship for income less than $16,000, but for incomes between $16,000 and $65,000, Social Security payments are lower for the corporation because of the salary allocation. Clearly, future Social Security benefits will also be lower with the corporation in these situations because of lower levels of qualified earnings. The maximum Social Security savings of the corporation amounts to approximately $550 at incomes between $25,000 and $35,000. For incomes in excess of $65,000, Social Security costs are $307 to $672 higher for the corporation than for the sole proprietorship.

Workers' Compensation and Unemployment Insurance

Other payroll taxes to consider in choosing a business organization are Workers' Compensation and Unemployment Insurance.[12] The coverage and requirements of Workers' Compensation vary by State, but, in general, sole proprietors are exempt, whereas, in some States, owner-employees and family employees of a corporation must be included in a Workers' Compensation program. The cost of coverage, usually incurred in the form of a premium on an insurance policy, may amount to 5 to 8 percent of the employee's salary.

Unemployment Insurance requirements also vary by State, but a Federal tax of 3.4 percent of the first $6,000 of wages is imposed if the employer pays $20,000 or more in wages in any calendar quarter or employs 10 or more individuals. Owner-employees must be covered if the conditions are met. While the basic requirements vary, the minimum cost of such insurance is $204 per employee that receives a minimum of $6,000 in wages. Over time, Unemployment Insurance rates may drop if the owner-employer does not make many small claims, because a firm's rates are based on its own experience.

Table 11 compares the aftertax cost of payroll taxes for a sole proprietor and an owner-employee in a corporation as well as for regular employees in a sole proprietorship and corporation. The costs presume that participation in Workers' Compensation, Unemployment Insurance, and Social Security, is mandatory for *all* employees.[13] Note that even though the employer's contributions to the various benefit programs are tax deductible, the aftertax cost of these payroll taxes is substantially higher for the farmer as an owner-employee of a corporation than as a sole proprietor, regardless of the corporate tax bracket. For example, if the farmer receives $30,000 in income as a sole proprietor, the payroll taxes would amount to $1,854.90 (6.1 percent of income); if the farmer received $30,000 in salary from a corporation, the payroll taxes would amount to 11.6 percent of the salary, $3,329, in a corporation taxed at the 20-percent bracket; if the corporation is in the 46-percent bracket the payroll tax would amount to 9 percent of the salary or $2,703.43. For salaries of $10,000, aftertax payroll taxes for owner-employees can amount to approximately 15 to 20 percent of salary in a corporation; for salaries of $50,000, such taxes amount to 5 to 7 percent of salary. Payroll taxes as a percentage of salary are lower for regular employees than for owner-employees of a corporation because the employee's contribution to Social Security is deducted from his salary and is assumed not to result in a direct cost to the owner of the firm in the case of regular employees, but a similar contribution by the owner-employee *does* result in a direct cost to the owner.

For most family farms, where the operator and family provide the majority of the labor and management, Workers' Compensation (at least in some States) and Unemployment Insurance are not mandatory. Thus the key income and payroll taxes to consider in the decision of whether or not to incorporate are income taxes and Social Security. Table 12 shows the combined Federal income and Social Security taxes for the sole proprietor and corporate-individual combination (again using the salary allocation procedure described earlier) for various levels of income, and the total tax savings (income plus Social Security) of the corporate alternative. With an income of about $16,000, the corporation

[12]Workers' Compensation is an insurance program whereby employees are compensated for work-related injuries or illnesses.

[13]Simulated costs are used in the table for the Unemployment Insurance and Workers' Compensation programs. The potential benefits in terms of protection from litigation are not considered in the computation.

Table 11—Federal income tax cost of payroll taxes for Social Security, Unemployment Insurance, and Workers' Compensation, corporate owner-employee and nonowner employee, 1979

Income or salary of each employee[1]	After-tax cost to sole proprietor[2,3]	Owner-employee: Before-tax cost of payroll taxes and owner's share of Social Security[4 5]	Owner-employee: After-tax cost to the owner-employee and corporation, Percent marginal tax bracket[6]: 20	30	40	46	Nonowner employee: Before tax cost of payroll taxes[4]	Nonowner employee: After-tax cost to a sole proprietor or corporation, Percent marginal tax bracket[6]: 20	30	40	46
						Dollars					
$10,000	810.00	2,230.00	1,906.60	1,744.90	1,583,20	1,486.00	1,617.00	1,293.60	1,131.90	970.20	873.00
$15,000	1,215.00	2,843.50	2,458.70	2,266.00	2,073.60	1,958.46	1,924.00	1,539.20	1,346.80	1,154.40	1,038.96
$20,000	1,620.00	3,456.00	3,010.00	2,727.00	2,564.00	2,430.20	2,230.00	1,784.00	1,561.00	1,338.00	1,204.20
$30,000	1,854.90	3,811.54	3,329.99	3,089.21	2,848.43	2,703.43	2,407.77	1,926.22	1,685.44	1,444.66	1,300.20
$50,000	1,854.90	3,811.54	3,329.99	3,089.21	2,848.43	2,703.43	2,407.77	1,926.22	1,685.44	1,444.66	1,300.20
	Percent of income					*Percent of salary*					
$10,000	8.1	22.3	19.1	17.4	15.8	14.9	16.2	12.9	11.3	9.7	8.7
$15,000	8.1	19.0	16.4	15.1	13.8	13.1	12.8	10.3	9.0	7.7	6.9
$20,000	8.1	17.3	15.1	13.6	12.8	12.2	11.2	8.9	7.8	6.7	6.0
$30,000	6.2	12.7	11.1	10.3	9.5	9.0	8.0	6.4	5.6	4.8	4.3
$50,000	3.7	7.6	6.7	6.2	5.7	5.4	4.8	3.8	3.4	2.9	2.6

[1]Total income or salary is assumed to be earned income subject only to Social Security tax for a self-employed proprietor. However, a self-employed sole proprietor may have employees and pay the same rate of Social Security tax and Unemployment Insurance and Workers' Compensation as is paid for corporate employees.

[2]Social Security taxes paid by a sole proprietor for himself or herself are not tax deductible.

[3]In 1979, a sole proprietor was taxed at 8.1 percent of earned income between $400 and $22,900. It was assumed that the sole proprietor received no off-farm income subject to the Social Security tax.

[4]In 1979, the employee and employer each were taxed at 6.13 percent of wages or salary up to $22,900. An employer is required to pay Social Security taxes on wages and salaries paid to an employee but is able to deduct such taxes from taxable income. While there is variation by State in Unemployment Insurance costs, we assumed that the employer was required to participate and paid the Federal rate of 3.4 percent of the first $6,000 of salary (including his salary), or $204 per employee. There is also variation between States in required Workers' Compensation coverage and costs. We assumed the employer was required to participate and paid a rate of $5 per $100 on $16,000 of coverage, or $800 per worker. Costs of Unemployment Insurance and Workers' Compensation are tax deductible items to an employer, whether a sole proprietor, partnership, or corporation. The latter two coverages are not required of a sole proprietor even if such a proprietor has sufficient employees to be required to cover them.

[5]The owner-manager is not able to deduct the cost of the 6.13 percent of salary that he or she must pay to the Internal Revenue Service for Social Security coverage.

[6]All the corporate marginal tax brackets are not shown.

Table 12—Federal tax savings after including Social Security taxes for a corporation and its owner-manager, by income, 1979[1]

Total income[2]	1 Sole proprietor: Social Security tax	Federal income tax	Total tax[3]	Tax as a percent of income	1 Corporation and its individual owner-manager: Social Security tax[4]	Individual tax	Corporation tax	Total tax	Tax as a percent of income	Total tax saving of corporation and owner-manager vs. sole proprietor
Dollars				Percent	Dollars				Percent	Dollars
4,000	324	0	324	8.1	490	0	0	490	12.3	-166
8,000	648	84	732	9.2	980	15	0	995	12.4	-263
12,000	972	702	1,674	14.0	1,422	630	0	2,052	17.1	-378
16,000	1,296	1,425	2,721	17.0	1,422	630	627	2,679	16.7	42
20,000	1,620	2,265	3,885	19.4	1,422	630	1,307	3,359	16.8	526
25,000	1,855	3,497	5,352	21.4	1,422	630	2,157	4,209	16.8	1,143
30,000	1,855	4,953	6,808	22.7	1,422	630	3,007	5,059	16.7	1,749
35,000	1,855	6,608	8,463	24.2	1,422	630	3,857	5,909	16.9	2,554
40,000	1,855	8,506	10,361	25.9	1,840	1,242	4,094	7,176	17.9	3,185
50,000	1,855	12,818	14,673	29.3	1,950	1,404	5,875	9,226	18.5	5,444
60,000	1,855	17,718	19,573	32.6	1,950	1,404	7,875	11,229	18.7	8,344
70,000	1,855	22,846	24,701	35.2	2,452	2,265	9,005	13,722	19.6	10,979
80,000	1,855	28,126	29,981	37.5	2,808	4,505	9,249	16,562	20.7	13,419
90,000	1,855	33,420	35,275	39.2	2,808	4,505	12,249	19,562	21.7	15,713
100,000	1,855	39,050	40,905	40.9	2,808	4,505	15,249	22,562	22.5	18,333
110,000	1,855	44,680	46,535	42.3	2,808	6,608	16,449	25,865	23.5	20,670
120,000	1,855	50,541	52,396	43.7	2,808	8,162	18,508	29,478	24.6	22,918
130,000	1,855	56,521	58,376	44.9	2,808	8,162	22,508	33,478	25.8	24,898
140,000	1,855	62,501	64,356	46.0	2,808	8,505	26,348	37,661	26.9	26,695
150,000	1,855	68,481	70,336	46.9	2,808	12,720	26,268	41,796	27.9	28,540
160,000	1,855	74,461	76,316	47.7	2,808	12,720	30,796	46,324	29.0	29,992
170,000	1,855	80,514	82,369	48.5	2,808	12,720	35,396	50,924	30.0	31,445
180,000	1,855	86,774	88,629	49.2	2,808	12,720	39,996	55,524	30.8	33,105
190,000	1,855	93,034	94,889	49.9	2,808	12,720	44,596	60,124	31.6	34,765
200,000	1,855	99,294	101,149	50.6	2,808	12,720	49,196	64,724	32.4	36,425
250,000	1,855	131,022	132,877	53.2	2,808	12,720	72,196	87,724	35.1	45,153
300,000	1,855	163,022	164,877	55.0	2,808	12,720	95,196	110,724	36.9	54,153
350,000	1,855	195,022	196,877	56.3	2,808	12,720	118,196	133,724	38.2	63,153
400,000	1,855	227,022	228,877	57.2	2,808	12,720	141,196	156,724	39.2	72,153
450,000	1,855	259,022	260,877	58.0	2,808	12,720	164,196	179,724	39.9	81,153
500,000	1,855	291,022	292,877	58.6	2,808	12,720	187,196	202,724	40.5	90,153
1,000,000	1,855	611,022	612,877	61.3	2,808	12,720	417,196	432,724	43.3	180,153

[1]The procedure used to allocate income between the owner-manager and the corporation is the same as that used in table 7 to minimize the total Federal income tax bill. The Social Security tax was calculated on the sole proprietor's total income subject to tax and on the gross salary of the owner-manager as shown at each income level in table 7.

[2]The amount of income reported for tax purposes prior to Social Security deductions and exemptions.

[3]The taxable income above $60,000 was taxed as a combination of personal services income and return to capital as described in table 8.

[4]Total Social Security tax for both a corporation and the individual owner-manager, each of which paid 6.13 percent of the gross salary. The corporation's contributions were a tax deduction.

pays lower total taxes than a sole proprietor, but the savings are almost insignificant. At $25,000 of net income, the tax savings of the corporation is $1,143; at $35,000, the savings exceed $2,500 and the tax savings increases rapidly at income levels above $35,000. If net income totals $100,000, the total tax savings from incorporation amounts to $18,333.

In most cases, additional costs of recordkeeping, filing tax returns, staying up-to-date on recent changes in tax laws, and an increased potential for tax audits will be incurred with the corporate structure, but if net income is $25,000 to $30,000 or more, the potential tax saving is large enough to offset those additional costs. A farming operation with approximately $500,000 of net worth that is earning a 5 to 6 percent rate of return would probably reduce its taxes by incorporating. Furthermore, as discussed in the next section, various fringe benefits may be available to owner-employees of a corporation at a lower aftertax cost than to sole proprietors.

Employee and Self-Employed Benefits

Many fringe benefit programs, like retirement plans, life insurance, and health and accident insurance, receive different tax treatment depending upon the type of business organization. The flexibility and options available to adopt tax-free fringe benefit programs also vary by legal entity. In general, the fringe benefit programs available to a corporation are more flexible and have a lower aftertax cost than those available to sole proprietorships or partnerships.

With respect to retirement plans, sole proprietors or partners can participate in Keogh or Individual Retirement Account (IRA) plans. With a Keogh plan, the sole proprietor can contribute 15 percent of earned income, up to a maximum of $7,500 per year, to a retirement plan. The contribution is tax deductible and earnings and capital appreciation are not taxed until the income is received at retirement. Keogh plans must include regular employees (some part-time and seasonal employees as well as those with only a few months of service can be excluded) and contributions to the plan by the employer cannot discriminate against employees. That is, if the employer contributes 15 percent of his or her income to the plan, the employer must also contribute 15 percent of the salary of his or her employees to the plan.[14]

With an IRA, 15 percent of compensation or income up to $1,500 can be contributed to a retirement plan and is tax deductible. IRA's can be set up by both a husband and a wife if they are both employed and up to $1,500 per year can be contributed by each. If only one spouse is employed, the contribution can be $1,750 per year, if contributions are made for both husband and wife. Furthermore, under certain conditions, an employer can make up to $7,500 of tax-free contributions to a simplified IRA pension account for an employee.

Corporate retirement plans allow contributions, under certain conditions, up to 25 percent of an employee's compensation with a maximum contribution of $32,700 in 1979. Various types of deferred compensation plans can also be developed with a corporate structure. Even though they may not qualify for tax deductions, such plans may still accomplish other employee compensation objectives.[15]

The tax savings potential of a retirement program depends upon the tax bracket of the various business entities. For example, if a corporation has taxable income between $50,000 and $75,000 (30 percent tax bracket), the aftertax cost of contributing $100 to a qualified retirement plan is $70, or for each dollar contributed, the corporation obtains a 30-cent reduction in taxes. Likewise a sole proprietor or partner in the 32-percent tax bracket can contribute $100 to a Keogh or IRA plan at an aftertax cost of $68. The farmer must also make contributions for all other employees (exceptions are again allowed for part-time and seasonal employees) in a corporation, but need not do so in a sole proprietorship or partnership if the contributions are made to an IRA.

If a corporation is formed and the income tax minimizing scheme (in table 7) is used to allocate $50,000 of income between the owner-manager and

[14]Through the use of multiple corporations, it is possible to structure the farm business in such a fashion as to not be required to include nonfamily employees in retirement and other fringe benefit programs. Good legal counsel should be obtained in structuring such an arrangement (7).

[15]The opportunity to use an Employee Stock Ownership Plan as part of the benefit and financing plan for a corporation is not discussed here because of the complexity of such plans and the regulations that are applicable. For a review of the potential use of these plans, see (37).

corporation, the marginal tax bracket of the corporation is 20 percent, so each dollar contributed to a retirement plan would cost 80 cents. A farmer with $50,000 of income would be taxed in the 49-percent bracket as a sole proprietor, so each dollar of retirement contributions would cost 51 cents. In this case, the corporate retirement plan has a higher aftertax cost, but the corporation is obtaining some offsetting savings in Federal income taxes from the division of income between the corporation and owner-manager.

Although sole proprietors and owner-employees in a corporation can both participate in tax-deferred retirement plans, the tax treatment of life, health, and accident insurance plans is quite different for the proprietorship and corporation. A corporation can acquire up to $50,000 of life insurance coverage for each employee with the premiums tax deductible to the corporation and not taxable income to the employee under a qualified group plan. Many States require a minimum of 10 employees to have a group plan, but "baby group" plans may include fewer employees. The premium payments on health and accident insurance for employees are also deductible to the corporation under certain conditions. To be tax deductible, insurance programs generally must not discriminate in favor of owner-employees or highly paid employees.

Premiums paid by a sole proprietor on life insurance policies are not tax deductible; half of the premium on health insurance policies is tax deductible in a sole proprietorship up to a maximum of $150, if the individual itemizes deductions on his or her personal return. Because of this difference in the tax treatment of such fringe benefit programs, the aftertax dollars needed to acquire a specified level of benefits can be substantially different in the corporation and sole proprietorship (table 13). For example, if the cost of $1,000 of term life insurance is $4, the net cost after Federal income taxes of such coverage for a corporation in the 30-percent tax bracket, assuming the policy qualifies as tax deductible, is $2.80. In contrast, a sole proprietor must pay for such coverage with aftertax income. A sole proprietor in the 32-percent tax bracket must receive $5.88 of before-tax income to have sufficient aftertax income to purchase the same coverage. Thus, the cost of the coverage is 52 percent lower for the corporation than for the sole proprietorship. Note that the aftertax costs of fringe benefits that are tax deductible to the corporation but must be purchased with aftertax income by the sole proprietor are from 30 to 72 percent less expensive for the corporation, depending upon the marginal tax brackets of the two.

In addition to the insurance fringes, a regular corporation may be able to deduct depreciation, maintenance, and repairs on a farm residence if the owner-employee is required to live in the residence as a condition of employment; a Subchapter S corporation can deduct such expenses only to the extent the residence is used for business purposes. The cost of food may also be deductible and is not

Table 13—Tax advantages of a corporation over a sole proprietorship in acquiring fringe benefits[1]

Corporation marginal tax bracket (percent)	Sole proprietor marginal tax bracket (percent)						
	16	21	28	32	37	43	49
	Percent reduction for corporation						
17	30	35	40	44	48	53	58
20	33	37	42	46	50	54	59
30	41	45	50	52	56	60	64
40	50	53	57	59	62	66	69
46	55	57	61	63	66	69	72

[1]These relative reductions were calculated by comparing the after-tax cost of purchasing tax deductible fringe benefits in a corporation to the additional after-tax income that a sole proprietor must earn to pay for the same benefits (the cost of which are not tax deductible to the sole proprietor). For example, the payment of $1 for term life insurance only costs $0.70 for a corporation in the 30-percent tax bracket if the premium is tax deductible. In contrast, a sole proprietor must pay for such coverage with after-tax income and the premium is not tax deductible; thus, a sole proprietor in the 28-percent tax bracket must earn $1.39 of additional income to have $1 of after-tax income to pay the premium. Consequently, the cost of this insurance policy is 50 percent lower for a corporation (($1.39 - $0.70) ÷ $1.39) than for a sole proprietorship.

taxable income to the employee if furnished for the convenience of the employer. However, deductions for such expenses as lodging and food are closely scrutinized by the IRS, particularly if taken on behalf of owner-employees (2, 26).

Estate and Gift Taxes

One of the reasons frequently cited for farm incorporation is to facilitate estate transfer. Making annual gifts to various family members of 1, 5, or 50 acres of a farm or a third or half of a farm machine per year is possible under a sole proprietorship, but very cumbersome. Transferring larger parcels of land may fragment an efficient farming operation. But transferring shares of stock in a farm corporation on an annual or periodic basis is a relatively simple and convenient way to transfer wealth to the heirs. Partnership interests can also be transferred if the partnership agreement so permits. Transfer of stock or partnership interests prior to or at death may help to keep the farm business operating at peak efficiency since farm heirs and off-farm heirs may be willing to maintain their ownership and leave their inherited capital in the farm business if they see that it will be operated efficiently and they will receive a reasonable return on their investment.

Current law provides that each individual can give up to $3,000 annually to each of as many people as he or she chooses with no gift or estate tax generally due. In addition, a credit against gift and estate tax due of $47,000 for gifts and deaths in 1981 and thereafter enables an individual to transfer approximately $175,000 during life or at death free of Federal gift or estate taxes. Tax rates for gifts or death transfers above $175,000 start at 32 percent and increase to 70 percent for estates above $5 million. Farmers and other small businessmen can also qualify for up to a $500,000 reduction in the value of the estate under special use value provisions for real estate. In addition, where the value of a closely held business makes up more than 65 percent of the adjusted gross estate, a 15-year installment payment of taxes can be used. Under this provision, interest on the first $1 million of a taxable estate ($345,800 of tax) less the unified credit attributable to farm or other closely held business property is at 4 percent per year. Furthermore, the payment schedule calls for interest payments only for the first 5 years, and equal installment payments on the tax plus interest for the remaining 10 years.

The 1976 Tax Reform Act included new gift and estate tax marital deductions. The gift tax marital deduction allows a deduction for the first $100,000 of gifts to a spouse, with the second $100,000 fully taxable and gifts in excess of $200,000 being one-half deductible. The estate tax marital deduction is equal to the greater of $250,000 or half of the adjusted gross estate reduced by the amount that the gift tax marital deduction utilized exceeds one-half of the gift.

Note that the same estate and gift tax rules apply to partnership and sole proprietorship property as well as to corporate property. However, as noted earlier, the corporate form of business organization may facilitate property transfers, particularly if property is transferred through gifts before death. Furthermore, if the value of the farm resources continues to increase rapidly, and the credit for gift and estate taxes is not increased, a program of annual gifts of stock will result in some of the appreciation accruing to the heirs rather than being taxed in the parents' estate.

The opportunity to use a combination of stock and debentures (or different classes of stock such as common and preferred) in the capital structure of the corporation makes incorporation a particularly attractive estate and retirement planning tool. In contributing assets to a corporation, a farmer can take back stock or a combination of stock and debentures. Debentures are debt instruments with a specified life (usually 10 to 15 years) and interest rate. The interest must be paid annually even if the corporation loses money.

A corporation capitalized with a combination of stock and debentures can simultaneously satisfy many estate and retirement planning goals. The interest payment on the debentures must be made so the debenture holders have a guaranteed income as long as they own the debentures. Debentures, therefore, represent an attractive and assured source of income to a retiring farm couple. The interest payments are tax deductible to the corporation; dividends, which may be an alternative source of retirement income, are not tax deductible to the corporation. A retired farmer could possibly receive additional retirement income in the form of a salary from the corporation or earnings in a sole proprietorship, but such salary or earnings, considered earned income under the Social Security rules, would probably make the farmer liable for payment of Social Security taxes and reduce the Social

Security retirement benefits that would otherwise be received. However, interest paid on debentures is not earned income, so full Social Security benefits can be received.

Because debentures are debt instruments of the corporation, they can also accomplish other estate-planning objectives, particularly when the family includes on-farm and off-farm heirs. An owner of debentures, unlike an owner of stock, has no management control. Consequently, at the death of the parents, the on-farm heir can receive the stock and have controlling interest and management authority and responsibility for the corporation. The off-farm heirs can be given debentures which do not have any management control, but generate an annual return in the form of interest. Since the debentures have a specified maturity, the off-farm heir cannot force the corporation and the on-farm heir to redeem them for cash until they mature. Thus, the on-farm heir obtains control of the corporation and need not pay the off-farm heirs in cash immediately, but the off-farm heirs receive an annual return on their inheritance. When the debentures mature, the off-farm heirs can take the debentures' face value in cash, or new debentures might be issued to refinance maturing ones. Various combinations of common and preferred stock as well as voting and nonvoting stock may also be useful in the capital structure of the corporation. Expert counsel is needed when using such arrangements, but a properly structured corporation can provide substantial flexibility in satisfying various estate and retirement planning goals, as well as reducing estate and income taxes.

Part III. Federal Tax Impacts on Illustrative Farms

A major advantage realized by an incorporated business stems from the U.S. tax code, although other characteristics, as analyzed in the previous sections of this report, can enhance or diminish that advantage. To show how the tax savings of incorporation could affect a farm business over a period of years, we projected what would be the cumulative financial effect of 10 years of operation as a sole proprietorship and as a corporation for eight illustrative farms, in different regions of the country and producing different commodities.

Characteristics of the Illustrative Farms

The general resources, enterprises, and financial situations in 1980 for each of the farms selected for analysis are summarized in table 14. The 8 farms are part of the 20 "typical farms" series developed for 1980 use by the U.S. Department of Agriculture to illustrate the income and returns for various types of farming under different price and production efficiency assumptions (*20*). The eight farms used in the analysis were chosen to reflect various geographic and commodity characteristics.

For each of eight representative farms analyzed, three different financial and tenure arrangements were evaluated—a full-owner with 100-percent equity (that is, no debt), a full-owner with 50-percent equity, and a part-owner with 67-percent equity. In addition, to illustrate the impact of the differential tax treatment of the sole proprietorship and corporation for different size farms, an Iowa corn-hog farm was evaluated at three different size levels (beginning equity of approximately $1 million, $2 million, and $3 million).

A computer-assisted business analysis program was used to analyze the selected illustrative farms.[16] The business analysis program is a financial simulator that provides computations of the financial and tax implications (total tax liabilities, accumulated net worth, consumption, and so forth) of different forms of business organizations for various beginning equity and asset ownership situations. Input required to analyze a particular situation includes the personal characteristics of the family (age of parents, age and number of on-farm and off-farm heirs) and the financial and resource characteristics of the farm including asset composition and ownership, debt, tax basis, and rates of return on different classes of assets.

In brief, the program generates the annual cash income based on specified annual rates of return for various assets and the asset composition of the firm, computes the level of income taxes and annual consumption based on specified tax and consumption functions, and then reinvests the residual income in business and personal assets which in turn impacts the size and asset composition of the firm in the subsequent year. In addition, the assets appreciate and/or depreciate at specified rates. So the resulting financial structure and growth of the firm are basically a function of initial asset composition, earnings on those assets, withdrawals for taxes and consumption and appreciation or depreciation in asset values. Based on this analysis, the annual and cumulative long-term, aftertax financial consequences of being organized as a sole proprietorship, partnership, regularly taxed corporation, and tax option corporation can be determined.

To make meaningful comparisons between the eight different illustrative farms, we assumed the same annual rates of return on assets and appreciation on real estate for all farms. We assumed that real estate yielded a 4-percent annual return after real estate taxes, operating and working (machinery, equipment, breeding stock, etc.) capital had a 9-percent annual return, and that real estate would appreciate at an annual compound rate of 8 percent. Family living expenses were taken out of the farm business each year according to a consumption curve that shows families spending more as farm income increases in the following fashion:

Net Farm Income	*Family living expenses*
$ 5,000	$ 5,138
$10,000	$ 7,734
$15,000	$ 9,824
$20,000	$11,642
$30,000	$14,788
$40,000	$17,523
$50,000	$19,989
$60,000	$22,051
$70,000	$24,151

Income taxes were computed annually according to the appropriate rate schedule (corporate or personal) and the level of taxable income that the firm's activities generated.

[16]A detailed discussion of the Iowa State University Computer Business Analysis Program is available in (*29*).

Corporate vs. Sole Proprietorship Growth

The major financial consequences for the eight illustrative farms for the two forms of business organization and the three financial-tenure arrangements for a 10-year projection period are shown in table 15. The results for the central Iowa corn-hog farm with 100-percent equity will be used to illustrate the type of information provided in table 15.

If the Iowa farm were organized as a sole proprietorship, accumulated equity would total $2,510,512 in 10 years, whereas ending equity would be $2,656,282 if the same farm were organized as a corporation. Accumulated taxes would total $242,366 for the sole proprietorship during the 10-year period compared with $145,501 for the corporation. The consumption level is the same for both business organization alternatives, averaging $19,051 per year. The contingent capital gains tax liability (the tax due on the capital gain if the entire proprietorship or corporation were sold in the 10th year) would be approximately $400,000 for both business entity alternatives; the contingent capital gains tax is slightly higher for the sole proprietorship in this and all other cases because even though the amount of capital gain is the same for both legal entities, the sole proprietor is in a higher average tax bracket than the owner-manager of the corporation. If assets or corporate stock are liquidated in the 10th year, the individual would pay tax on any gain at the 70-percent rate for the sole proprietor and the 54-percent rate for an owner-manager of the corporation. If the gain qualifies as long-term gain, only 40 percent of the grain is subject to tax.

The tax treatment of the corporation compared with that of the sole proprietorship results in a more rapid rate of annual growth in equity and lower annual tax liabilities as a proportion of income. The annual growth rate for the Iowa farm organized as a sole proprietorship is 9.83 percent, compared with 10.45 percent for the corporation. Taxes as a percent of income are 22.2 for the sole proprietorship compared with 14.92 for the corporation in the first year, and 41.19 percent for the proprietorship compared with 24.64 percent for the corporation in year 10. The 10-year average tax liability is 30.64 percent of income for the sole proprietorship compared with 18.92 percent for the corporation.

Note that the 10-year tax savings of the corporate structure for the Iowa farm total $96,865, whereas the additional equity accumulation for the corporation compared with the sole proprietorship is $145,770. The larger additional equity accumulation compared with the tax savings illustrates the compounding effect of the tax savings for the corporation in the earlier part of the 10-year period. Thus, the tax benefits of the corporation occur in two forms: the first is the direct benefit of lower taxes and the second is the compound value of the tax savings as they are reinvested in the farm business.

For all eight illustrative farms with 100-percent equity, the accumulated equity in 10-years is larger for the corporation compared with the sole proprietorship. The largest tax savings of incorporating occurs for the largest farm which has the highest income and is thus in the highest tax bracket; by incorporating, the Washington Palouse winter wheat farm saves $197,250 in taxes over the 10-year period. The smallest savings occurs for the Ohio soybean-grain farm which would save $68,219 of taxes by incorporating. The compound growth rate is 0.63 to 0.96 percentage point higher with the corporate structure and average taxes as a percentage of income are 10.57 to 17.91 percentage points lower with the corporation.

For the farms with 50-percent equity, the tax savings from incorporation are not as large as for the same farms with 100-percent equity. This occurs primarily because the higher leveraged farms have lower taxable incomes and thus are in lower tax brackets where the tax rates for the corporation and the sole proprietorship are similar. In fact, during the first year of the period, taxes as a proportion of income are higher for the corporation compared with the sole proprietorship for the Ohio, Iowa, Missouri, Oklahoma, and Georgia farms.[17] By the end of the projection period, however, all of the 50-percent equity farms had grown sufficiently that taxes as a proportion of income were lower for the corporate alternative.

The tax savings from incorporation total only $23,070 for the Ohio soybean-grain farm with 50-percent equity compared with $68,219 for the same farm with 100-percent equity. For the Washington Palouse winter wheat farm, the tax savings total $112,353 assuming 50-percent equity compared with $197,250 with 100-percent equity. As expected, the smaller tax savings result in a smaller difference between the rates of growth in equity for the corporation compared with a proprietorship for the more highly leveraged farms.

[17]This occurs because of the salary allocation being used; the tax-minimizing salary allocation procedure discussed in earlier sections was not completely implemented but only approximated in the computer analysis.

Table 14—Resource, enterprise, and financial characteristics of selected illustrative farms, 1980

Characteristics	Ohio soybean-grain	Southwest Illinois corn-soybean	Central Iowa corn-hog	Northeast Missouri beef-hog	Southwest Oklahoma cotton–beef cow	Southwest Georgia peanut	Montana winter wheat	Washington Palouse winter wheat
RESOURCE AND ENTERPRISE				*Acres*				
Crops:								
Barley	0	0	0	0	0	0	220	200
Bermuda pasture	0	0	0	90	0	0	0	0
Clover pasture	0	0	0	50	0	0	0	0
Coastal hay	0	0	0	0	0	15	0	0
Coastal pasture	0	0	0	0	0	60	0	0
Corn	95	200	150	100	0	220	0	0
Cotton	0	0	0	0	140	0	0	0
Dry peas	0	0	0	0	0	0	0	200
Hay	0	0	0	0	50	0	0	0
Native pasture	0	0	0	0	0	60	0	0
Pasture	0	0	0	0	320	0	0	0
Peanuts	0	0	0	0	0	125	0	0
Soybeans	90	180	125	80	0	0	0	0
Spring wheat	0	0	0	0	0	0	200	0
Wheat	0	0	0	0	420	0	0	0
Fallow	0	0	0	0	0	0	1,360	600
Winter wheat	35	0	0	0	0	0	940	250
Total acres:								
Crop	220	380	275	260	610	360	2,720	1,250
Pasture	0	0	30	60	320	120	0	0
Other	20	20	15	40	30	100	320	30
Total	240	400	320	360	960	580	3,040	1,280
				Number of head				
Livestock:								
Beef cows	0	0	0	35	30	50	0	0
Sows (farrow to finish)	0	0	50	20	0	0	0	0
				Work years				
Labor:								
Operator	.6	1	1	1	1	1	1	1
Salaried (full-time)	0	0	0	0	0	1	0	0
				Hours				
Family	78	169	482	233	261	432	502	302
Hourly (part-time)	44	152	931	279	30	155	487	348
FINANCIAL								
Full owner, 100-percent equity:				*Dollars*				
Assets:								
Land and improvements	474,487	980,829	768,115	428,864	678,350	454,000	1,012,651	1,029,821
Machinery and equipment	122,046	132,987	130,381	146,948	124,826	168,243	134,307	240,591
Livestock	0	0	10,728	20,076	12,905	18,700	0	0
Personal:								
Financial[1]	39,967	74,625	60,918	38,579	54,147	43,818	76,846	85,118
Household[2]	8,351	15,593	12,729	8,061	11,314	9,156	16,067	17,786
Total	644,851	1,204,034	982,871	642,528	881,542	693,917	1,239,871	1,373,316

See footnotes at end of table.

Continued—

Table 14—Resource, enterprise, and financial characteristics of selected illustrative farms, 1980—Continued

Characteristics	Ohio soybean-grain	Southwest Illinois corn-soybean	Central Iowa corn-hog	Northeast Missouri beef-hog	Southwest Oklahoma cotton-beef cow	Southwest Georgia peanut	Montana winter wheat	Washington Palouse winter wheat
				Dollars				
Liabilities:								
Land and improvements	0	0	0	0	0	0	0	0
Machinery and equipment	0	0	0	0	0	0	0	0
Livestock	0	0	0	0	0	0	0	0
Total	0	0	0	0	0	0	0	0
Equity	644,851	1,204,034	982,871	642,528	881,542	693,917	1,239,871	1,373,316
Full owner, 50-percent equity:								
Assets[3]	644,851	1,204,034	982,871	642,528	881,542	693,917	1,239,871	1,373,316
Liabilities:								
Land and improvements	237,244	490,414	384,058	214,432	339,175	227,000	506,326	514,910
Machinery and equipment	61,023	66,493	65,190	73,474	62,413	84,121	67,154	120,296
Livestock	0	0	5,364	10,038	6,453	9,350	0	0
Personal:								
Financial	19,984	37,313	30,459	19,289	27,074	21,909	38,423	42,559
Household	4,175	7,797	6,365	4,031	5,657	4,578	8,034	8,893
Total	322,425	602,017	491,436	321,264	440,772	346,958	619,935	686,658
Equity	322,426	602,017	491,435	321,264	440,770	346,959	619,936	686,658
Part owner:[4]								
Assets:								
Land and improvements	242,131	502,004	413,584	238,435	346,733	240,076	532,734	525,448
Machinery and equipment	122,046	132,987	130,381	146,948	124,826	168,243	134,307	240,591
Livestock	0	0	10,728	20,076	12,905	18,700	0	0
Personal:								
Financial[1]	24,399	42,554	37,164	25,820	31,929	28,610	44,691	51,324
Household[2]	5,099	8,889	7,766	5,395	6,672	5,978	9,338	10,724
Total	393,675	686,434	599,623	436,674	523,065	461,607	721,070	828,087
Liabilities:								
Land and improvements	117,224	209,668	173,820	115,147	151,762	114,900	213,142	210,738
Machinery and equipment	40,682	44,329	43,460	48,983	41,609	56,081	44,769	80,197
Livestock	0	0	3,576	6,692	4,301	6,234	0	0
Personal:								
Financial	8,133	14,181	12,388	8,607	10,643	9,537	14,897	17,108
Household	1,699	2,963	2,588	1,798	2,224	1,993	3,112	3,574
Total	167,738	271,141	235,832	181,227	210,539	188,745	275,920	311,617
Equity	225,937	415,293	363,791	255,447	312,526	272,862	445,150	516,470

[1]Calculated as 6.7 percent of the business assets (land and improvements, machinery and equipment and livestock), based on USDA data for farms with gross sales in excess of $100,000, from the *Balance Sheet of the Farming Sector, 1979 Supplement*, AIB-430, USDA, February 1980, table 32, page 36.

[2]Calculated as 1.4 percent of the business assets (land and improvements, machinery and equipment and livestock), based on USDA data for farms with gross sales in excess of $100,000, from the *Balance Sheet of the Farming Sector, 1979 Supplement*, AIB-430, USDA, February 1980, table 32, page 36.

[3]Same assets as full owner, 100-percent equity.

[4]Part-owners own 50 percent of the real property they operate and cash rent the remaining 50 percent; they have a 67-percent equity in their assets.

Table 15—Financial consequences over a 10-year period of the use of a sole proprietorship compared to a corporation for eight illustrative farms with three different tenure financial structures

Financial consequences	Ohio soybean-grain		Southwest Illinois corn-soybean		Central Iowa corn-hog		Northeast Missouri beef-hog	
	Sole proprietorship	Corporation	Sole proprietorship	Corporation	Sole proprietorship	Corporation	Sole proprietorship	Corporation
	Dollars							
100-percent equity:								
Increase in equity	1,043,827	1,141,314	1,781,545	2,018,047	1,527,642	1,673,412	1,023,016	1,124,050
Ending equity	1,668,678	1,786,164	2,985,579	3,222,081	2,510,512	2,656,282	1,645,468	1,746,501
Accumulated total taxes	154,558	86,339	326,452	173,658	242,336	145,501	158,705	88,191
Average annual consumption	16,130	16,130	20,641	20,641	19,051	19,051	16,264	16,264
Contingent capital gains tax	246,521	240,034	498,729	494,540	402,974	394,110	234,121	228,110
	Percent							
Annual rate of growth in equity	10.10	10.73	9.51	10.34	9.83	10.45	10.21	10.87
Tax as a percent of income:								
Year 1	17.09	13.81	28.75	15.75	22.20	14.95	17.39	13.87
Year 2	18.72	14.30	30.58	16.15	24.30	15.99	19.01	14.36
Year 10	36.70	19.61	45.66	27.85	41.19	24.64	37.15	19.89
Annual average	26.53	15.96	36.12	19.83	30.64	18.92	26.86	16.04
Individual marginal tax bracket[1]	59	37	64	28	70	54	59	37
	Dollars							
50-percent equity:								
Increase in equity	943,900	972,791	1,642,823	1,747,604	1,399,525	1,442,348	927,495	965,900
Ending equity	1,266,417	1,295,218	2,224,841	2,349,621	1,890,959	1,933,753	1,238,722	1,277,127
Accumulated total taxes	78,273	55,203	166,864	89,288	118,084	82,489	83,000	52,106
Average annual consumption	14,056	14,056	16,486	16,486	15,654	15,654	14,245	14,245
Contingent capital gains tax	235,563	235,563	485,750	472,582	397,117	378,869	223,695	212,467
	Percent							
Annual rate of growth in equity	14.66	14.92	14.07	14.59	14.43	14.68	14.81	15.16
Tax as a percent of income:								
Year 1	9.77	10.73	14.74	13.09	9.63	11.93	10.37	10.99
Year 2	11.22	11.57	17.11	13.68	11.83	13.79	11.82	11.79
Year 10	31.96	17.06	40.24	22.11	35.61	20.54	32.63	16.76
Annual average	18.87	14.05	27.71	16.00	21.83	15.55	19.43	13.87
Individual marginal tax bracket[1]	54	24	59	28	59	28	54	24
	Dollars							
Part-owners:[2]								
Increase in equity	616,333	640,947	1,010,000	1,074,853	939,111	954,020	661,543	694,077
Ending equity	842,677	867,291	1,380,155	1,490,579	1,302,892	1,317,801	904,096	936,630
Accumulated total taxes	62,019	41,967	113,657	65,483	77,367	63,348	73,036	47,400
Average annual consumption	13,522	13,522	14,735	14,735	14,549	14,549	13,925	13,925
Contingent capital gains tax	125,685	119,216	253,524	243,366	227,012	211,234	134,371	127,191
	Percent							
Annual rate of growth in equity	14.05	14.38	13.12	13.62	13.61	13.73	14.06	14.47
Tax as a percent of income:								
Year 1	10.49	10.77	14.28	12.53	7.99	10.51	11.63	11.20
Year 2	11.98	11.39	16.12	13.06	9.75	13.03	12.95	11.00
Year 10	29.11	15.74	35.72	18.14	30.63	18.00	31.02	16.34
Annual average	17.84	13.09	24.11	14.58	17.14	14.51	19.30	13.46
Individual marginal tax bracket[1]	49	24	54	24	54	24	54	24

Continued—

See footnotes at end of table.

Table 15—Financial consequences over a 10-year period of the use of a sole proprietorship compared to a corporation for eight illustrative farms with three different tenure financial structures—continued

Financial consequences	Southwest Oklahoma cotton-beef cow		Southwest Georgia peanut		Montana winter wheat		Washington Palouse winter wheat	
	Sole proprietorship	Corporation	Sole proprietorship	Corporation	Sole proprietorship	Corporation	Sole proprietorship	Corporation
				Dollars				
100-percent equity:								
Increase in equity	1,349,905	1,509,527	1,153,917	1,298,771	1,828,335	2,075,793	2,030,449	2,340,406
Ending equity	2,223,541	2,383,164	1,860,891	2,005,744	3,068,205	3,315,663	3,403,765	3,713,722
Accumulated total taxes	223,928	117,153	205,663	108,893	338,335	176,953	432,351	235,101
Average annual consumption	17,995	17,995	17,494	17,494	20,926	20,926	22,908	22,908
Contingent capital gains tax	351,123	345,920	267,099	261,746	512,724	514,691	562,576	565,814
				Percent				
Annual rate of growth in equity	9.79	10.56	10.16	10.99	9.48	10.34	9.50	10.46
Tax as a percent of income:								
Year 1	23.62	14.72	22.35	14.48	29.20	16.02	32.60	16.66
Year 2	23.47	15.30	24.02	14.93	31.12	16.46	34.33	17.71
Year 10	40.88	22.52	40.23	21.99	46.08	27.36	49.03	30.47
Annual average	31.25	17.17	30.20	16.83	36.59	19.67	39.92	22.01
Individual marginal tax bracket[1]	64	37	59	37	64	37	68	37
				Dollars				
50-percent equity:								
Increase in equity	1,236,201	1,300,442	1,028,612	1,085,581	1,687,087	1,797,050	1,883,773	2,042,955
Ending equity	1,677,016	1,741,257	1,369,042	1,426,011	2,306,969	2,416,931	2,587,583	2,746,766
Accumulated total taxes	115,227	65,867	106,321	61,675	173,055	92,108	235,163	122,810
Average annual consumption	15,016	15,016	14,888	14,888	16,654	16,654	18,305	18,305
Contingent capital gains tax	339,259	325,776	247,860	235,921	501,618	488,449	549,128	538,012
				Percent				
Annual rate of growth in equity	14.29	14.73	14.93	15.40	14.05	14.58	13.91	14.59
Tax as a percent of income:								
Year 1	12.06	12.13	11.55	11.86	15.33	13.11	18.60	13.89
Year 2	14.07	12.83	13.20	12.57	17.66	13.70	23.36	14.48
Year 10	35.88	18.83	35.05	18.32	40.65	22.62	44.48	26.29
Annual average	23.21	14.70	22.34	14.97	28.16	16.14	32.04	17.63
Individual marginal tax bracket[1]	54	24	54	24	59	28	64	28
				Dollars				
Part-owners:[2]								
Increase in equity	786,695	826,384	741,531	789,453	1,057,987	1,130,022	1,231,115	1,356,115
Ending equity	1,094,383	1,134,072	1,014,393	1,062,315	1,503,584	1,575,618	1,747,585	1,872,585
Accumulated total taxes	82,833	52,290	93,552	57,172	122,192	69,385	184,412	98,370
Average annual consumption	13,945	13,945	14,598	14,598	14,943	14,943	16,665	16,665
Contingent capital gains tax	177,659	168,922	151,659	143,337	269,258	259,160	30,007	297,595
				Percent				
Annual rate of growth in equity	13.53	13.93	14.03	14.56	12.93	13.46	12.96	13.75
Tax as a percent of income:								
Year 1	12.31	11.74	13.18	11.77	15.20	12.66	18.75	13.66
Year 2	13.98	12.33	14.64	12.34	16.83	13.17	23.11	14.08
Year 10	32.43	16.49	34.02	17.14	36.40	18.63	41.03	22.56
Annual average	20.53	13.83	21.78	14.11	24.93	14.81	30.03	16.00
Individual marginal tax bracket[1]	54	24	54	24	54	24	59	24

[1]The individual marginal tax bracket applicable to the first dollar of sale of capital assets.

[2]Part-owners own 50 percent of the real property they operate and cash rent the remaining 50 percent; they have a 67-percent equity in their assets.

The tax savings of incorporation are even less significant for the part-owner farms. For the Ohio soybean-grain farm the corporation saves only $20,052 in taxes compared with the proprietorship over the 10-year period. The largest tax savings for the part-owner farms ($86,042) again occurs for the Washington Palouse farm because it has more income and is in higher tax brackets.

To illustrate the differences in tax liabilities for the corporation compared with the sole proprietorship for different size farms, additional analyses were completed for the Iowa illustrative farm (100-percent equity) with an equity position double and triple that shown in table 14. With an initial equity slightly less than $2 million, the tax savings of incorporation compared with the sole proprietorship totals $168,176 during the 10-year period (table 16). The difference in ending equity in this case between the proprietorship and corporation is $271,127. When the firm starts with an initial equity of approximately $3 million, the tax savings of the corporate structure totals $216,095 and the ending equity is $346,566 larger with the corporation than with the proprietorship. As the initial size of the firm increases, the size of the tax savings and the benefits in terms of equity growth increase but at a decreasing rate.

Table 16—Financial consequences over a 10-year period of the use of a sole proprietorship compared to a corporation for a Central Iowa corn-hog farm, 100-percent equity, three beginning size levels

Financial consequences	Illustrative farm size: $982,871 of equity		Double illustrative farm size: $1,965,742 of equity[1]		Triple illustrative farm size: $2,948,613 of equity[1]	
	Sole proprietorship	Corporation	Sole proprietorship	Corporation	Sole proprietorship	Corporation
	Dollars					
Increase in equity	1,527,642	1,673,412	2,930,045	3,201,173	4,314,247	4,660,816
Ending equity	2,510,512	2,656,282	4,895,787	5,166,914	7,262,860	7,609,426
Accumulated total taxes	242,366	145,501	569,192	401,016	922,788	706,693
Average annual consumption	19,051	19,051	27,426	27,426	34,276	34,276
Contingent capital gains tax	402,974	394,110	841,729	836,295	1,276,445	1,271,343
	Percent					
Annual growth rate	9.83	10.45	9.55	10.15	9.43	9.94
Tax as a percent of income:						
Year 1	22.20	14.92	29.58	18.39	33.50	23.42
Year 2	24.30	15.99	31.08	21.60	36.11	28.68
Year 10	41.19	24.64	49.68	35.01	53.53	39.04
Annual average	30.64	18.92	38.88	27.20	43.23	33.02
Marginal tax bracket[2]	70	54	70	59	70	59

[1]The beginning equity situation shown in table 14 was doubled and tripled.
[2]The individual marginal tax bracket applicable to the sale of capital assets.

Part IV. Farm Incorporation and the Organization of U.S. Agriculture

Policymakers may be interested in the ramifications, if any, if the trend toward farm incorporation continues on the same scale as occurred from 1974 to 1978. Some of the issues raised by the increasing numbers of farm corporations include: the efficiency of corporations versus sole proprietorships in use of resources, in production, in adoption of technology, in preservation of natural resources; the distribution of farm wealth; the capability of the traditional farm financial institutions to serve incorporated farmers' credit needs; the adequacy and accuracy of the data that identify the farm and the farmer (particularly if nonfarm heirs hold farm securities); and the willingness of farm corporations to respond to traditional farm programs (commodity reduction and price support programs, for example).

Assuming that the number of incorporated farms will probably continue to increase, it may be useful to speculate on the types of firms that will make increased use of the corporate structure. The growth in corporate use will likely come from at least three different groups of farmers and nonfarmers.

- One group includes farmers with modest size farms and net worths and who will incorporate primarily for estate planning and transfer purposes. They may file their Federal income tax returns under regular or tax option provisions.

- The second group, which is probably the one that will increase corporate farm numbers the most, includes family farmers who will incorporate not only for estate planning purposes, but, more important, to facilitate farm growth. These farmers face higher taxable incomes, which can be partly offset by lower corporate tax rates. This group has been and will continue to be the group that provides the greatest competition for other farmers when farmland becomes available for purchase or lease.

- The third group includes new farming operations formed by nonfarm investors and by companies operating in other parts of the food system or in other sectors of the economy. The nonfarm investor corporations may be owned or operated by individuals or by small syndicates whose owners are merchants, professional workers, and so forth. The established companies that enter farming may be closely held or public corporations with no dominant individual owner.

For the most part, past concerns about nonfarm corporations taking over farming have been unfounded. Those concerns were that large nonagricultural firms and outside investors will form farm corporations and enter agricultural production, competing with family farmers for farm resources. To date, this has not happened in the production of most agricultural products; rather the modest increase in the number of corporations involved in farm production has come from family farmers who incorporated their business for the various reasons discussed earlier in this report. It is now more generally recognized that the small and moderate size farmers' greatest competition for farm resources, particularly farm real estate, is coming from moderate and large size farmers. Some of the most competitive farmers are those who incorporated their businesses and were the focus of earlier sections in this report.

Earlier analyses in this report indicate that the tax savings of incorporation become significant when taxable income exceeds $25,000-$30,000. Because of the time involved in, and the added expenses of, incorporating, some farmers will require larger tax savings before they incorporate; other farmers will incorporate when their taxable income is substantially below this level for reasons other than immediate tax savings such as for estate planning and transfer purposes. Some small farmers also may elect to file their Federal income tax returns under tax option provisions.

With an increasing number of corporations being formed by groups with diverse economic interests and financial characteristics, the central future economic issues will probably revolve about whether the corporate structure, both at the farm production level and throughout the rest of the food system, encourages or discourages efficiency in resource use, preservation and development of natural resources, and development and adoption of efficient technology. Additional issues include overall income and wealth distribution, the ability of financial institutions to meet the needs of the changing farm production sector, and the development of the emerging farm advising industry to assist corporate farms to meet societal objectives. Attention will also be given to the overall implications of an increasing number of corporate farms on concentration of agricultural landownership and use.

Incorporation is expected to encourage farm growth and increases in farm size because larger aftertax income is available for reinvestment. If many (mostly larger) farms do incorporate, and by incorporating are able to continue their growth, then a number of policy questions will probably be raised that revolve around the nature of the emerging dichotomy in U.S. agriculture: moderately large, farm corporations versus smaller, but more traditional, sole proprietorship farms. Efficiency in use of resources is usually the first economic criterion used to analyze the impact of changing farm size. Available economies of size studies are too outdated to firmly establish the point at which a farm firm reaches optimal size in resource use. It is likely to be much larger than was thought possible even a few years ago since machines and associated equipment have since been introduced with substantially more capacity than the largest available machines a decade ago. Also, industrial and financial management principles and practices are increasingly being adopted by larger firms. However, if size economies are not large or not passed through to consumers in the form of lower prices, larger scale corporate farms may not be as desirable from an economic efficiency point of view.

In addition, larger firms are frequently able to analyze and more readily adopt new farm technology that becomes available, particularly technology that is size dependent as to cost (i.e., some technology is efficient only when used on large operations). An end result of the successful adoption of new technology is more efficient use of resources including purchased inputs as well as the farmer's labor and management. Fewer but larger farms may also encourage improved efficiency in the farm input and product and processing markets. Suppliers and marketing firms may be able to achieve economies in large quantity bulk handling, storage, and buying and selling. When input firms, and marketing and processing firms are able to reduce costs through efficient resource use, consumers may benefit from a more abundant, higher quality, lower priced food supply when competitive markets exist.

Larger farms may be more likely to undertake more intensive conservation measures, particularly where present owners and managers have plans to tranfer the farm to the next generation and are adequately capitalized. Such farmers are generally the early adopters of new machines and equipment, which recently have included soil- and energy-saving minimum tillage. Large-scale farmers can also construct waterways and terraces and install subsurface and surface tile drainage where necessary in the most effective way. They may have a sufficient income level and tax burden to benefit from provisions in the Internal Revenue Code that are designed to encourage soil conservation. However, larger farm firms may not universally be soil- and water-conservation effective; depending on owner and management attitude, they may operate under short-term profit-maximizing criteria that may be inconsistent with long-term soil conservation expenditures. Nonetheless, well capitalized farm corporations with intergeneration ownership and operational objectives should be less likely to engage in short-term soil exploitation.

Longer term resource efficiency may result when farmers use a corporate form of business organization to attract younger managers and owners who keep the farm operation at peak efficiency over several generations. In some cases, however, firms may become large and profitable enough so that a future generation of owners, able to live off of past achievements, will not change the firm to stay in the lead in technological innovation and efficiency. While a farm firm may be able to exist in such a state for a few years, it is unlikely that it can exist for very long under the competitive pressures from other farm firms.

Large, efficient farms that remain incorporated over several generations may affect landownership patterns and the financing needs of agriculture. Currently, farmland is owned in relatively small tracts and is frequently offered for sale or lease from estates every generation or two. If larger tracts of land are put together and held by farm corporations that stay in business and grow over several generations, the amount of farmland that will be available for purchase or rent could decrease substantially.

Where farmland and other resources are owned by the same corporation through several generations, the potential exists for multiple ownership of farm resources to increase. This has several possible implications. Nonfarm heirs may continue to leave their investment in the corporation over two or more generations. They may even purchase additional shares of stock with income obtained from their nonfarm employment, investments, and inheritance of spouses. If this phenomenon develops, the need for institutional credit to refinance each new generation of farm ownership could decline. Such a source of financing, however, is unlikely to be adequate to meet the full financing needs of farms that expand and continually adopt new and more costly technology.

There may be a need to develop a secondary market for farm corporate stock and debentures since some farm heirs will want money in exchange for some or all of their inheritance from the farm. Public development of such markets may be in society's interest if the intergenerational corporation accomplishes society's objectives. Development of such markets may involve some form of private or public assessment or rating of farm debentures and stock.

Corporations can more easily accommodate multiple ownership of resources; thus, one would expect a more diverse pattern of resource ownership (that is, more people, like nonfarm heirs, maintaining an ownership interest in farm assets), but more concentration of control over resource use because of larger and fewer total farms with a larger proportion being organized as a corporation. More nonfarm ownership of agricultural resources will also make the farm sector more financially interdependent with the nonfarm sector.

Finally, there may be at least three implications for government policy if farm corporations become more numerous and the number of sole proprietorships declines.

First, identifying the farm may become more difficult and require a modification to the present Federal data system that has recognized and analyzed a "farmer" and his or her "farm" as one and the same entity. Future identification and description of the owners, managers, firms, and the resources used by the firm will become more difficult.

Second, the response to Federal commodity programs may change. Participation in Federal commodity acreage reduction and price-support programs by the larger corporate farms may be substantially different from that of smaller farmers. In addition, attitudes toward risk taking could be different if the limited liability feature of the corporate form of business organization is a dominant reason for incorporating. As corporate farms increase and if Federal farm commodity programs continue, frequent study and monitoring of the response of such farms to alternative programs may be needed.

Third, the rate of the federally funded extension and experiment station programs may change as more of the larger family farms incorporate. Incorporation involves the firms' complying with a more complex set of Federal tax regulations and filings as well as other more complex legal requirements. These requirements not only necessitate more and better recordkeeping, but also usually require the services of specialized attorneys, accountants, and financial advisors—not only for the initial incorporation work but also on an ongoing basis to stay abreast of and evaluate changes in tax regulations, court rulings, and changing financial conditions. In addition, larger farm firms, regardless of the form of business organization used, also make more extensive use of consultants and outside advisors in such specialties as crop and livestock chemicals, materials handling, soil fertility, plant selection and care, recordkeeping and analysis, and farm input and product prices analysis. This relatively new farm industry has started to develop as a supplement to, and in some cases as a replacement for, the traditional role that the Agricultural Extension Service and the Federal-State Experiment Stations have had in providing information and assistance to farmers.

Unfortunately, the U.S. data system is not yet developed to the extent that the necessary financial and demographic variables are available to explain fully the likely number of farms that will use the various forms of business organizations by size of farm, commodity, and area of the country. The national data system has been a system that provides input for supply, demand, and price analysis for agricultural commodities and provides enumeration of the number of farm firms for Federal fund allocations. The system will likely continue its present emphasis for the foreseeable future so that all the necessary data on changes in farm business organization and why farmers make such changes will not be available. However, it may be possible to make trend projections of the future number of farms by type of farm business organization after the agricultural data become available from the 1978 U.S. Census of Agriculture. Preliminary data indicate that the number of farm corporations has increased by about 90 percent. Further increases may be expected as inflation increases farm income subject to Federal taxation and as some farms grow in physical volume as well.

To date, policymakers for the most part have not explicitly considered the economic impact of tax policy on agriculture. This has especially been the case with regard to corporate tax rates which were reduced for firms with less than $100,000 of taxable income, in part to favor small businesses, while bracket creep was permitted to continue for sole proprietors and partnerships. For the most part, the rate-decreasing provisions were enacted with larger businesses in mind than most farms. However, some farm firms are large enough to benefit from the tax reductions. This phenomenon, which has largely been unnoticed in the agricultural public policy arena, suggests a need for closer monitoring, analysis, and debate of future Federal income tax proposals to identify those that may affect the farm production sector.

References

Experiment Station and Extension Service publications from several States where readily available are included in the list. Since farm business organization issues and problems often involve State laws and regulations as well as Federal statutes, readers are encouraged to contact their State Experiment and Extension Service for the latest available information.

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Appendix table 1—Minimum Federal income tax liability for a sole proprietorship, an individual owner-manager, and a corporation at various income levels, 1969 and equivalent 1979 income adjusted for inflation[1]

1969													
	Sole proprietor				Individual owner-manager and corporation								
					Individual owner-manager				Corporation				
Total income[2]	Taxable income[3]	Marginal tax bracket[4]	Total tax	Tax as a percent of income	Income[5]	Taxable income[3]	Marginal tax bracket	Total tax	Taxable income[6]	Marginal tax bracket	Total tax	Total tax: individual owner-manager and corporation	Tax as a percent of total income
Dollars		*Percent*	*Dollars*	*Percent*	*---Dollars----*		*Percent*	*----Dollars----*		*Percent*	*-----Dollars----*		*Percent*
2,000	0	0	0	0	2,000	0	0	0	0	0	0	0	0
4,000	1,000	14	140	3.5	4,000	1,000	15	140	0	0	0	140	3.5
6,000	3,000	17	450	7.5	6,000	3,000	16	450	0	0	0	450	7.5
8,000	4,800	19	772	9.7	8,000	4,800	19	772	0	0	0	772	9.7
10,000	6,600	19	1,114	11.1	10,000	6,600	22	1,114	0	0	0	1,114	11.1
12,000	8,600	22	1,512	12.6	12,000	8,600	22	1,512	0	0	0	1,512	12.6
14,000	10,600	22	1,874	13.4	14,000	10,600	22	1,874	0	0	0	1,874	13.3
16,000	12,600	25	2,385	14.9	15,400	12,000	22	2,260	0	0	0	2,392	15.0
18,000	14,600	25	2,910	16.2	15,400	12,000	22	2,260	600	22	132	2,832	15.7
20,000	16,600	28	3,428	17.1	15,400	12,000	22	2,260	2,600	22	572	3,272	16.4
25,000	21,600	32	4,892	19.6	15,400	12,000	22	2,260	4,600	22	1,012	4,372	17.5
30,000	26,600	36	6,596	22.0	15,400	12,000	22	2,260	9,600	22	2,112	5,472	18.2
35,000	31,600	39	8,036	23.0	15,400	12,000	22	2,260	14,600	22	3,212	6,572	18.8
40,000	36,600	42	10,610	26.5	15,400	12,000	22	2,260	19,600	22	4,312	7,672	19.2
45,000	51,600	48	12,908	28.7	20,000	16,600	28	3,428	24,600	22	5,412	8,928	19.8
50,000	46,600	50	15,360	30.7	25,000	21,600	32	4,892	25,000	22	5,500	10,392	20.8
55,000	41,600	50	17,860	32.5	30,000	26,600	36	6,492	25,000	22	5,500	11,992	21.8
60,000	56,600	53	20,498	34.2	35,000	31,600	39	8,504	25,000	22	5,500	14,004	23.3
65,000	61,600	53	23,148	35.6	40,000	36,600	45	10,610	25,000	22	5,500	16,100	24.8
70,000	66,600	55	25,740	36.8	45,000	41,600	48	12,908	25,000	22	5,500	18,408	26.3
75,000	71,600	55	28,490	38.0	47,400	44,000	48	14,060	27,600	48	6,748	20,808	27.7
80,000	76,600	58	31,368	39.2	47,400	44,000	48	14,060	32,600	48	9,148	23,208	29.0
85,000	81,600	58	34,268	40.3	47,400	44,000	48	14,060	37,600	48	11,548	25,608	30.1
90,000	86,600	58	37,100	41.2	47,400	44,000	48	14,060	42,600	48	13,948	28,008	31.1
95,000	91,600	60	41,400	42.3	47,400	44,000	48	14,060	47,600	48	16,348	30,408	32.0
100,000	96,600	60	43,140	43.1	47,400	44,000	48	14,060	52,600	48	18,748	32,808	32.8
150,000	146,600	66	74,736	49.8	47,400	44,000	48	14,060	102,600	48	42,748	56,808	37.9
200,000	196,600	69	108,634	54.1	47,400	44,000	48	14,060	152,600	48	66,748	80,808	40.4
250,000	246,600	70	143,600	57.4	47,400	44,000	48	14,060	202,600	48	90,748	104,808	41.9
300,000	296,600	70	178,600	59.5	47,400	44,000	48	14,060	252,600	48	114,748	128,808	42.9
400,000	396,600	70	248,600	62.2	47,400	44,000	48	14,060	352,600	48	162,748	176,808	44.2
500,000	496,600	70	318,600	63.7	47,400	44,000	48	14,060	452,600	48	210,748	224,808	45.0
1,000,000	996,000	70	768,600	76.8	47,400	44,000	48	14,060	952,600	48	450,748	464,808	46.5

See footnotes at end of table.

Continued—

Appendix table 1—Minimum Federal income tax liability for a sole proprietorship, an individual owner-manager, and a corporation at various income levels, 1969 and equivalent 1979 income adjusted for inflation—continued

1979													
Income adjusted for inflation[2,7]	Sole proprietor				Individual owner-manager and corporation								
					Individual owner-manager				Corporation			Total tax: individual owner-manager and corporation	Tax as a percent of total income
	Taxable income	Marginal tax bracket[8]	Total tax	Tax as a percent of income	Income[5]	Taxable income[9]	Marginal tax bracket	Total tax	Taxable income[6]	Marginal tax bracket	Total tax		
Dollars	*Dollars*	*Percent*[9]	*Dollars*	*Percent*	*Dollars*	*Dollars*	*Percent*	*Dollars*	*Dollars*	*Percent*	*Dollars*	*Dollars*	*Percent*
3,920	0	0	0	0	3,920	0	0	0	0	0	0	0	0
7,920	3,920	14.0	78	1.0	7,920	3,920	14	73	0	0	0	73	.9
11,880	7,880	18.0	680	5.7	11,600	7,600	16	630	280	17	48	678	5.7
15,840	11,840	21.0	1,393	8.8	11,600	7,600	16	630	4,240	17	721	1,351	7.2
19,800	15,800	21.0	2,223	11.3	11,600	7,600	16	630	8,200	17	1,394	2,024	10.2
23,760	19,760	24.0	3,167	13.3	11,600	7,600	16	630	12,160	17	2,067	2,697	11.3
27,720	24,720	32.0	4,543	16.4	11,600	7,600	16	630	16,120	17	2,740	3,340	12.1
31,680	27,680	32.0	5,491	17.3	11,600	7,600	16	630	20,080	17	3,414	4,044	12.7
35,640	31,640	37.0	6,845	19.2	11,600	7,600	16	630	24,040	17	4,087	4,717	13.2
39,400	35,400	43.0	8,248	20.1	14,400	10,400	18	1,134	25,000	17	4,250	5,384	13.7
49,500	45,500	43.0	12,591	25.4	15,900	11,900	18	1,404	33,600	20	5,970	7,374	14.9
59,100	55,400	49.0	17,520	29.5	15,900	11,900	18	1,404	43,500	20	7,950	9,354	15.7
69,300	65,300	52.8	24,760	32.4	19,300	15,300	21	2,118	50,000	20	9,250	11,368	16.4
79,200	75,200	52.8	27,703	35.0	28,600	24,600	28	4,505	50,600	30	9,430	13,935	17.6
89,100	85,100	52.8	33,030	37.1	28,600	24,600	28	4,505	60,500	30	12,400	16,905	19.0
99,000	95,000	56.3	38,586	39.0	28,600	24,600	28	4,505	70,400	30	15,370	19,875	20.0
108,900	104,900	56.3	44,160	40.1	33,900	29,900	32	6,201	75,000	30	16,750	22,951	21.1
118,800	114,800	59.8	49,923	42.0	39,200	35,200	37	8,162	79,600	40	18,590	26,752	22.5
128,700	124,700	59.8	55,843	43.4	39,200	35,200	37	8,162	89,500	40	22,550	30,712	23.9
138,600	134,600	59.8	61,763	44.6	39,200	35,200	37	12,161	99,400	40	26,510	34,672	25.0
148,500	144,500	59.8	67,683	45.6	48,500	44,500	43	12,720	100,000	40	26,750	38,911	26.2
158,400	154,400	59.8	73,603	46.5	49,800	45,800	43	12,720	108,600	46	30,706	43,426	27.4
168,300	164,300	62.6	79,639	47.3	49,800	45,800	43	12,720	118,500	46	35,260	47,980	28.5
178,200	174,200	62.6	85,836	48.2	49,800	45,800	43	12,720	128,400	46	39,814	52,534	29.5
188,100	184,100	62.6	92,033	49.0	49,800	45,800	43	12,720	138,300	46	44,368	57,088	30.3
198,000	194,000	62.6	98,230	49.6	49,800	45,800	43	12,720	148,200	46	48,922	61,642	31.1
297,000	293,000	64.0	161,280	54.3	49,800	45,800	43	12,720	247,200	46	94,462	107,182	36.1
396,000	392,000	64.0	224,640	56.0	49,800	45,800	43	12,720	346,200	46	140,002	152,722	38.6
495,000	491,000	64.0	288,640	58.3	49,800	45,800	43	12,720	445,200	46	185,542	198,262	40.1
594,000	590,000	64.0	352,000	59.3	49,800	45,800	43	12,720	544,200	46	231,082	243,802	41.0
792,000	788,000	64.0	478,720	60.4	49,800	45,800	43	12,720	646,200	46	322,162	334,882	42.3
990,000	986,000	64.0	605,440	61.2	49,800	45,800	43	12,720	840,200	46	413,242	425,962	43.0
1,980,000	1,976,000	64.0	1,239,040	62.6	49,800	45,800	43	12,720	1,830,200	46	868,642	881,362	44.5

See footnotes on next page.

Continued—

Footnotes to appendix table 1

[1]Total income was allocated between the individual owner-manager and the corporation so as to minimize the total tax bill. The principle used in this allocation was to equate the marginal tax brackets between the taxpaying entities. Since differences in bracket structure between the corporate and personal tax rate made it impossible to equate the brackets exactly, the procedure used was to maximize the amount of income allocated to the taxpaying entity with the lower bracket. For example, in 1969 for the case of an individual owner-manager and corporation, and $50,000 of income, $25,000 of income is allocated to the owner-manager and taxed at the 36-percent marginal bracket. If an additional dollar of income had been allocated from the owner-manager to the corporation, it would have been taxed at 48 percent (the corporate tax rate increased from 22 to 48 percent for income above $25,000) thus increasing the total tax bill by 12 cents per dollar. In practice, the allocation between the corporation and the individual owner-manager can be accomplished by appropriate setting of salaries, directors' fees, and other forms of compensation. IRS regulations require such compensation be reasonable and based on services rendered.

[2]The amount of income reported for tax purposes prior to deductions and exemptions.

[3]The 1969 personal exemption for husband and wife and each child was $600; thus, $2,400 was subtracted from total income. The 1969 standard deduction of 10 percent of adjusted gross income up to $1,000 maximum was also subtracted from total income.

[4]The rates shown in the Tax Rate schedules were used in the computations. The surcharge of 10 percent of the tax liability imposed for the January through December 31, 1969 period, and adjustments to it for small amounts of tax liability ($735 or less) and retirement income credit reduction were not included.

[5]The amount of income reported for tax purposes prior to deductions and exemptions. The amount of income allocated to the owner-manager in relation to total available income for allocation may appear low; however the owner-manager may not need or want more income that would be taxed at a higher rate, particularly where some otherwise personal expense items are paid for by the corporation and are not considered as taxable income to the owner-manager but are deductible corporate expenses.

[6]Income reported and taxed at corporate rates.

[7]The equivalent income in 1979 was obtained by adjusting the 1969 income by the Consumer Price Index; 1969 was 109.8, 1979 was 217.4 (1967 = 100).

[8]Only part of the income from farming is considered to be personal service income and thus, subject to the maximum 50-percent tax on earned income. Prior to 1979, 30 percent of farm income was assumed to be earned or personal service and 70 percent was capital or other earnings. These rules were changed for tax years beginnihg in 1979; currently the rules require a "reasonable" allocation of farm income to personal services. Because the new rules have been in effect for only a year and do not provide a substantive base for dividing income between personal services income, and other earnings, the rules in effect prior to 1979 (30 percent personal service or earned income, 70 percent other income) were used. Thus, any income above $60,000 in 1979 would be taxed at the 54-percent bracket if it were not subject to the maximum 50-percent rule on earned income. For example, at $65,000 of income, $5,300 is subject to the maximum tax on earned income rules, but only 30 percent of this income can qualify as earned income. Thus, the marginal tax bracket at this income level is calculated as $(.30 \times .50) + (.70 \times .54) = .528$ or 52.8 percent.

[9]The 1979 personal exemption for husband and wife and each child was $1,000; thus $4,000 was subtracted from total income. The 1979 standard deduction of $3,400 for married taxpayers filing joint returns is reflected in the tax table.

*U.S. GOVERNMENT PRINTING OFFICE : 1981 0-340-932/ESS-114

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